Shari'ah and Legal Risk Issues in Sukuk Structures: An Analytical Case Study on SABIC Sukuk in Saudi Arabia

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by

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Abstract

As part of the Islamic financial development, Islamic capital markets have been developing in terms of structures and instruments in the last two decades. In particular, *sukuk* or Islamic bond market has proved to be a successful instrument for long-term project financing. While developments in *sukuk* market have demonstrated success, *sukuk* structures are not immune to various risk dimensions including *Shari'ah*, legal and regulative risks as well as financial risks.

This study, hence, aims to explore and examine three particular non-financial risk areas relating to *sukuk* structures in the case of SABIC *sukuk*, which was issued in three tranches in Saudi Arabia in the years 2006, 2007 and 2008. In doing so, this research particularly examines the risks emerging from the performance of *Shari'ah* Board in charge of the *Shari'ah* compliancy of SABIC *Sukuk* as well as *Shari'ah* compliancy and legal risks.

In order to examine the identified risk areas, in addition to rendering an in-depth literature based critical analysis in discursive nature, elite interviews were conducted with the *Shari'ah* scholars involved in the issuance of SABIC *sukuk*. In addition, in an attempt to provide non-*Shari'ah* perspective, finance professionals, lawyers, academics and technocrats were also interviewed to explore their understandings of the three identified risk areas in the case of SABIC *sukuk* in particular, and *sukuk* in general.

Since the AAOIFI standards have asserted that the *Shari'ah* Supervisory Board (SSB) has to be involved in controlling as well as monitoring *sukuk* structures from the time of issuance until maturity, which is expected to provide guarantee of the performance of the product in a *Shari'ah* compliant manner. This aims to ensure that the progress and performance will not veer from the right track of *Shari'ah* through close investigation and follow up by the members of SSB. This study found that one of the risks emerging from the SSB is that the *Shari'ah* supervision based on AAOIFI standards is still not observed and implemented by many SSBs. The findings indicate that a clear method and mechanism for the SSB members to conduct their examination for *Shari'ah* complicacy has not been established; and for this end, a comprehensive *fatwa* will play an essential role in ensuring *sukuk* structure *Shari'ah* compliant. Another finding is that the failing of issuing a binding and a comprehensive standard for SSBs to follow as well as clear methods to be implemented have resulted many *Shari'ah* and legal risks.

With regards to *Shari'ah* risks, the findings show that any inconsistency with the rules and principles of *Shari'ah* will lead *sukuk* to be *Shari'ah* incompliant. The inconsistency between *sukuk* structures issued in the Saudi Arabian market and AAOIFI standards is considered as a *Shari'ah* risk, as there still exist some major similarities between SABIC *sukuk* structure and *riba*-based bonds structure. Therefore, an array of *Shari'ah* issues needs to be resolved, which include ownership and the related issues in the sense of 'real ownership', the guarantee of the capital and returns, distribution of profits based on LIBOR instead of the performance of the project, the reserve account and the related issues.

As for legal risks, this research established that the absence of a special law featuring *sukuk* in Saudi Arabia is considered to be the main legal risk faced by Islamic capital markets in the country. The findings also show that the rules and regulations issued by the CMA have failed to provide a specific law related to *sukuk*, which might expose *sukuk* holders to the risk of treating *sukuk* as *riba*-based loan bonds. However, failure to differentiate between *sukuk* and bonds might lead to certain risks such as the failure of *sukuk* holders to become incapable of proving their rights regarding their ownership of the assets they carry. Consequently, the legal position of *sukuk* holders is unclear in the Saudi Arabian market, which is due to the absence of a *sukuk* law. Therefore, it is necessary that the regulatory and legislative bodies in Saudi Arabia should provide a suitable legislative and regulatory environment for the issuance of *sukuk* taking in consideration the legal and *Shari'ah* risks that *sukuk* structures might be exposed.

TABLE OF CONTENTS

LIST OF ABBREVIATIONS

AAOIFI: Accounting and Auditing Organisation for Islamic Financial Institutions

IBF: Islamic banking and finance

IDB: Islamic Development Bank

GCC: Gulf Co-operation Council

IIFM: International Islamic Financial Market

USD: United states Dollar

SSB: Shari'ah supervisory boards

SABIC: Saudi Arabia Basic Industries Corporation

SBSS: Shari'ah board of SABIC sukuk

CMA: Capital Market Authority

OIC: Organisation of Islamic Conference

UK: United Kingdom

IFSB: Islamic Financial Services Board

LMC: Liquidity Management Centre

PLS: Profit and Loss Sharing contracts

DIFC: Dubai International Financial Centre

SPV: Special purpose vehicle

GSR: Global Sukuk Report

NCCR: National Competitiveness Centre Report

SAMA: Saudi Arabian Monetary Agency

CML: Capital Market Law

SEC: Saudi Electricity Company

CRSD: Committee for the Resolution of Securities Disputes

ACRSC: Appeal Committee for the Resolution of Securities Conflicts

SAAB: Saudi Arabia British Bank

IFSB: Islamic Financial Services Board

GDP: Gross Domestic Product

LIBOR: London Interbank Offered Rate

SIBOR: Singapore Interbank Offered Rate

PISS: Prospectus Issuance of SABIC Sukuk

FSMA: British Financial Services and Market Act

CIS: Collective Investment Scheme

LIST OF TABLES

LIST OF FIGURES

DECLARATION

I hereby declare that this study has not been used in support of an application for another degree or qualification of this or any other University or institution of learning.

STATEMENT OF COPYRIGHT

DEDICATION

To my great parents *Abdullah and Ajoharah* who were always praying for me.

May Allah bless them and grant them the highest place in *Jannah*

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Chapter 1

INTRODUCTION

1.1 INTRODUCTION

While Islamic banking in its commercial form emerged in 1975, the formation of Islamic financial and capital markets is rather new. As part of the Islamic capital markets, the emergence of *sukuk* or Islamic bonds in late 1990s has contributed to the expansion of Islamic financial development globally.

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), one of the main standard setting body in Islamic banking and finance (IBF) industry, in its accounting standard describes *sukuk* as an investment grade product in order to delineate them from shares and bonds. It defines *sukuk* as (AAOIFI, 2010):

> certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the *sukuk*, the closing of subscription and the employment of funds received for the purpose for which the *sukuk* were issued.

Sukuk have become a prominent type of financing for corporations and also governments over the years, and hence the *sukuk* market has been receiving encouraging support from all walks of financial industry beyond the Muslim countries. Being the main instrument and constituents of the Islamic capital markets, it has provided additional financial flexibility to Islamic financing (Mohamad and Shah, 2010). Therefore, it has become a premier investment mechanism all over the world.

In the short period of time, initially from 1990 when the first *sukuk* issued and since 2000 when *sukuk* has become a popular capital market tool, *sukuk* have played a significant impact in the development of Islamic finance as well as in contributing to the economic growth and success of Muslim economies and others around the world (Asutay, 2010). The success of *sukuk* can be attributed to a number of factors, such as economic and financial needs, desire of Muslim investors to find safe and attractive

instruments for their businesses and the effort of Muslim scholars to find alternatives with the objective of eliminating all the prohibited investments in *Shari'ah,* and importantly also the need for the operationalizing of Islamic capital markets (Duaabah, 2009).

All these factors were behind the prosperity and the emergence of Islamic financial products in general and *sukuk* in particular. Despite having a relatively new Islamic capital markets with *sukuk*, the emergence of IBF can be traced back to early 1970s with the establishment of the Islamic Development Bank (IDB) in 1974 and Dubai Islamic Bank, as a commercial Islamic bank, in 1975 with the objective of supplying *Shari'ah* compliant commercial and retail banking activities and services (Usmani, 2002). After the success of IBF institutions since then, there has been demand, from different corners of the financial system mainly in the Gulf Co-operation Council (GCC) region as well as South-east Asia, for capital market instruments for the management of their balance-sheet liquidity (Tariq and Dar, 2007).

In responding to the demand for the development of capital market instruments, the Islamic *Fiqh* Academy held a conference in Saudi Arabia in 1988 (Adam and Thomas, 2004). As a result of the conference, proposal for *sukuk* were upheld and legitimized, namely considered as *Shari'ah* compliant, which has facilitated the way for Islamic issuers and investors to invest their placements under the *Shari'ah* principles without any need for dealing with the conventional debt securities since then.

Sukuk is considered as indispensable vehicle for resource mobilisation for liquidity, long-term project financing and infrastructure financing, whether in the public or private sector (Adam, 2005). However, this type of investment finance differs from the conventional bonds, as *sukuk* are principally structured to be backed by real assets, rather than be simply paper derivatives or dependent on issuers guarantee to pay back the debt with the stated interest as stated on the prospectus (Al-amine, 2008). Conventional bonds that are primarily based on interest are prohibited under the *Shari'ah* law, as one of the essential principles of IBF is the prohibition of interest, but also speculation and uncertainty or *gharar* (Obaidullah, 2001).

The main characteristics of conventional bonds are as follows (Adam and Thomas, 2004; Ayub, 2005; Usmani, 2007; Al-Amine, 2008);

(i) bonds do not represent ownership on the part of the bondholders, rather, they document the interest-bearing debt owed to the holders;

(ii) bonds holders are entitled to a regular amount of interest determined as a percentage of the capital and not as percentage of enterprise's profit;

(iii) the issuers of the bonds have to guarantee the return of principal when due, regardless of whether the commercial enterprise is making profit or not. It is basically a financial claim to a cash flow.

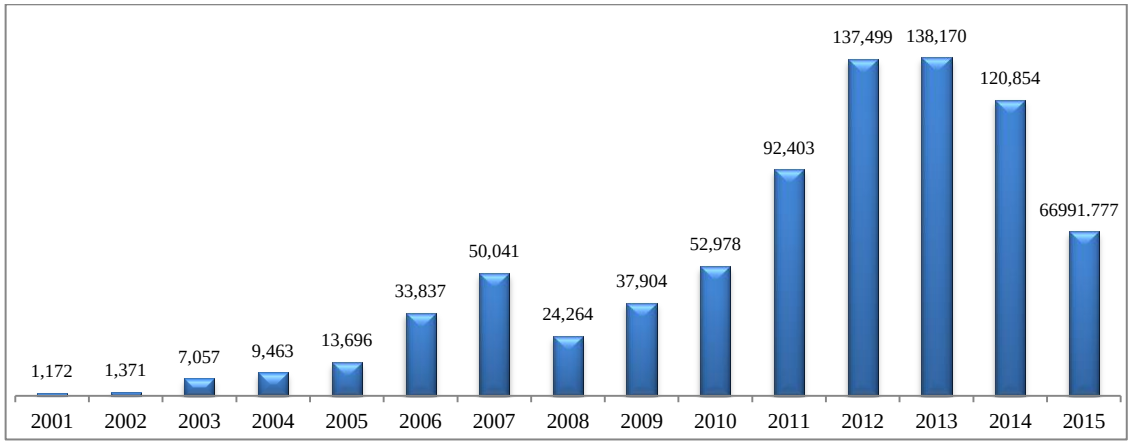
Due to such features, conventional bonds cannot be considered as lawful under the *Shari'ah* law, which provides the basis for IBF in general and *sukuk* in particular. Consequently, one of the distinguishing features of Islamic finance is that it must involve the funding of trade in, or the production of, real assets (Wilson, 2004). Therefore, *sukuk* is defined as "an entitlement to right in certain assets inclusive of some degree of asset ownership" (Adam and Thomas, 2004:42). This implies that the investors have a beneficial interest in the cash flow generated by the underlying assets. The cash flow represents a proportion of the returns generated by the assets in one of the following *sukuk* structures or contracts: *ijarah, mudarabah, musharakah, murabahah, istisnaa and salam* (Al-amine, 2008).

In terms of trajectory of development, the first *sukuk* was issued in Malaysia in 1990 with USD30 million by a foreign company (Ahmad and Radzi, 2011). In the year 2000, the first sovereign *sukuk* was issued by the Sudanese governments in the form of *musharakah sukuk* with Sudanese Pound 77 million. Since then, the financial and corporate sectors as well as sovereigns have been exploiting the benefits of *sukuk*. During the period between 2001 and 2007 the issuances of *sukuk* increased gradually from USD 1,172 million to USD 50,041 million (IIFM, 2010). The volume and the magnitude of issuances in the period in question indicate the success of *sukuk* market as well as the confidence of both *sukuk* issuers and *sukuk* holders. However, as a result of global financial meltdown, the *sukuk* issuance was declined dramatically to USD 24,264 million in 2008 and USD 37,904 million in 2009 (IIFM, 2010). While the IBF industry managed to keep its resilience, the performance of the general

industry and in particular the *sukuk* market was impacted by the adverse developments in the financial markets all over the world and in particular in the GCC region (Kumah *et al.*, 2010).

It should, however, be noted that with the global financial markets recovering, in 2010 *sukuk* market regained its vitality and activity with USD 52,978 million (Zawya, 2015). As can be seen from the Figure 1.1, there is an increasing trend in the global *sukuk* issuances after the decline accrued in 2008. Such a development has to be considered in spite of all difficulties and challenges in the global capital and financial markets. Thus, the developments indicate that the volume of *sukuk* issuance has returned to pre-crisis issuance level after establishing confidence in the market.

Figure 1.1: Global *Sukuk* Issuances, 2001- 2015 ($M)



Data Source: IIFM *Sukuk* Database (2014); Zawya Database (2015)

In terms of *sukuk* issuances, as depicted in Figure 1.1, the total global *sukuk* issuance rose from USD 1,172 million in 2001 to approximately USD 120,854 million at the end of 2014 with total USD 787,704 million from 2001 to 2015 (IIFM, 2014; Zawya, 2015). According to IIFM (2014) and Zawya (2015), the development of *sukuk* market is more concentrated in Malaysia in terms of both value and volume. The largest domestic *sukuk* issuance remains in Malaysia with 78.09% by value of domestic *sukuk*, whereas the second country is Saudi Arabia with 6.08%. The other countries such as UAE, Indonesia, Bahrain, Sudan, Brunei, Pakistan and Turkey claims about 21% of the total *sukuk* issuance so far by value of domestic *sukuk.* Saudi Arabia in this respect in 2014 was the leading *sukuk* issuance country in the Middle East (IIFM, 2014).

In Saudi Arabian market, *sukuk* were initially transacted in an over-the-counter market, meaning that they were executed through bank treasuries and settled by Saudi Stock Exchange (*Tadawul*). However, *Tadawul* has launched an automated order-driven secondary market. The introduction of the new platform is intended to encourage investors to participate more actively in the *sukuk* trade, which implies that with the new system, investors can buy and sell *sukuk* through their brokers (Al-Jasser and Banafe, 2005). However, it is aspired that Saudi Arabia being one of the leading economies in the Muslim world should engage more with IBF in general and *sukuk* and Islamic capital markets in particular.

There is no doubt that the global financial crisis was a test for the Islamic financial products such as *sukuk* (Kayed and Hassan, 2011). Therefore, Islamic financial institutions have benefited from the global crisis significantly, as the financial crisis helped to diversify the products in the Islamic financial markets and not solely focusing on only one product as well as to review and re-examine a number of issues such as ownership rights.

1.2 STATEMENT OF RESEARCH PROBLEM

While the global financial crisis affected the performance of Islamic finance industry in general, IBF industry in general and the *sukuk* market in particular was hit strongly by the global financial crisis in 2007-2008 despite having no main or major failures or bail outs but some *sukuk* defaults. In investigating the impact of the crisis on the *sukuk* market, as mentioned above, issuance fell to a near four-year low of USD 0.9 billion in the final quarter of 2008 and prices dropped by 18% in the fourth quarter and bottomed a further 5% lower in mid-February (IIFM, 2011). Thus, the issuances had slowed throughout 2008 as problems in banking sector intensified and leading scholars questioned the *Shari'ah*-compliance of some *sukuk* structures (Van Wijnbergen and Zaheer, 2013). Despite the recovery of *sukuk* market during 2009, there are on-going challenges. It is because during 2008 and 2009, the *sukuk* market was tested in several instances by its ability to deal with several defaults (Radzi, 2011). Recent data indicate that the *sukuk* markets globally have picked up again and issuance of *sukuk* in terms of volume and the magnitude is getting better as indicated in Figure 1.1(IIFM, 2014; Zawya, 2015). However, dramatic decline in the oil prices has recently re-affected the observed expansion and issuances in the *sukuk* market.

Since 2009, after a number of *sukuk* defaults, the financial markets and investors have been concerned about the efficiency of the existing laws and regulation to deal with *sukuk*, its structure and its level of *Shari'ah* compliance as an asset (Ab Majid *et al.*, 2011). Other concerns include ability of the structure to be supported by enabling legislation, contract enforcement measures and effective settlement dispute mechanisms (Ahmed, 2006). In addition, *sukuk* require a legal and regulative framework, which takes on board the distinctive characteristics of *sukuk.* This necessitates a competent legal and financial framework to achieve the following (AAOIFI, 2010; Islamic *Fiqh* Academy's Decisions No 177(3/19), 178(4/19), 188(3/20); Tariq and Dar, 2007; Idris, 2008; Salah, 2010; Oseni, 2014; Nazar, 2015):

(i) to identify the right of each parties involved in *sukuk* contract;
(ii) the validity of *sukuk* from *Shari'ah* perspective, as it assumes that the practice of *sukuk* call for primarily for strict *Shari'ah*-compliance to be integrated into the structure;
(iii) enabling legislation for its creation and the authorisation of *sukuk*, establishing *shari'ah* governance, and addressing conflicts between existing law and Islamic law;
(iv) enforceability of the contract by assurances that the legal documentation of any transactions or instruments comply with both *Shari'ah* and local law;
(v) formation of an appropriate mechanism for dispute settlement;
(vi) catering for risks underlying *sukuk* structures.

These issues are fundamentally important because they have given rise to legal uncertainty in the recent *sukuk* defaults. In addition, such issues have demonstrated the exposure of Islamic finance and in particular *sukuk* for *Shari'ah* and legal risk along with financial risk, which undermines the moral high ground of Islamic finance but also the performance of *sukuk*. It is, hence, the aim of this study to explore the *Shari'ah* and legal risk exposures of *sukuk* issuances in Saudi Arabia by focusing on Saudi Arabia Basic Industries Corporation (SABIC) *sukuk*, which is mainly one of the largest issuances so far.

1.3 AIMS, OBJECTIVES AND RESEARCH QUESTIONS

This study aims to explore and examine *Shari'ah* and legal risks associated with *sukuk* structures that have been issued in Saudi Arabia. Such an investigation is located within the contemporary regulatory and legal framework in Saudi Arabia by focusing on a main *sukuk* issuance namely SABIC *sukuk*. In other words, the related laws and also of the process of *sukuk* issuance as well as *Shari'ah* requirements and standards are examined in the case of SABIC *sukuk*, which is the largest issuance in Saudi Arabia by one of the largest holding company in the country.

To fulfil the aims of this study, the following objectives have been developed:

(i) to identify the dominant *sukuk* structures in practice in general and in Saudi Arabia in specific;

(ii) to highlight the main functions of the *Shari'ah* supervisory boards (SSB) from the issuing of *sukuk* to the time of maturity;

(iii) to evaluate the extent to which the current practices of *sukuk* fulfil the *Shari'ah* principles with consideration to AAOIFI rules;

(iv) to analyse the justifications or *fatawa* of Saudi *Shari'ah* scholars on the practice of various *sukuk* structures;

(v) to examine how *sukuk* are perceived by existing laws in Saudi Arabia and identify the existing gaps in the legal framework and financing structures with the objective of determining legal risks associated with *sukuk*;

(vi) to identify regulatory and legislative framework for *sukuk* in Saudi Arabia;

(vii) to critically examine the legal, regulative, *Shari'ah* and *Shari'ah* Supervisory Board related risks in the case of SABIC *sukuk*.

Based on the aim and objectives the following research questions are developed:

(i) What are the salient characteristics of the *sukuk* structures issued in Saudi Arabia?

(ii) What are the main risks associated with the functioning of the *Shari'ah* supervisory boards or SSB, which are in charge with structuring and monitoring the current *sukuk* issued in Saudi Arabia?

(iii) What are the main *Shari'ah* risks faced by these *sukuk* structures in particular the SABIC *sukuk*?

(iv) What are the main legal risks faced by these *sukuk* structures in particular the SABIC *sukuk*?

(v) What have been the consequences of *Shari'ah* and legal risks faced by Saudi *sukuk* structures in particular SABIC *sukuk*?

1.3.1 Mapping and Matching the Objectives and the Research Questions

It should be mentioned that there are seven research objectives and five research questions identified in this research. The following, aims to present the match between objectives and research questions and identify the particular chapter where a particular objective is tackled and a particular research question is responded.

Objective 1: to identify the dominant *sukuk* structures in practice especially the *sukuk*, which have been issued in Saudi Arabia. This is dealt with in Chapter 2 and Chapter 3 by responding to the following research question: (i) What are the salient characteristics of the *sukuk* structures issued in Saudi Arabia?

Objective 2: to highlight the main functions of the *Shari'ah* supervisory boards from the issuing of *sukuk* to the time of maturity. This objective is explored in Chapter 5, which provided interviews, with *Shari'ah* supervisory board members who were in charge of approving SABIC *sukuk* as well as with specialists in *sukuk* structures with regard to the significance of SSB, to answer the following research question: (ii) What are the main risks associated with the function of the *Shari'ah* supervisory boards who are in charge in structuring and monitoring the current *sukuk* issued in Saudi Arabia?

Objective 3: to evaluate the extent to which the current practices of *sukuk* fulfil the *Shari'ah* principles with consideration to AAOIFI rules. In responding to this objective, Chapter 6 provides critical analysis with *Shari'ah* supervisory board

members who were in charge of approving SABIC *sukuk*, which attempts to answer the following research question: (iii) What are the main *Shari'ah* risks faced by these *sukuk* structures in particular the SABIC *sukuk*?

Objective 4: to analyse the justifications or *fatawa* of Saudi *Shari'ah* scholars on the practice of various *sukuk* structures. Chapter 6 focuses on this objective by responding to the following research question: (iv) What are the main *Shari'ah* risks faced by these *sukuk* structures in particular the SABIC *sukuk*?

Objectives 5 and 6: to examine how *sukuk* are perceived by existing laws in Saudi Arabia and to identify the existing gaps in the legal framework and financing structures with the objective of determining legal risks associated with *sukuk*; as well as to identify an infrastructure in terms of regulatory and legislative frameworks for *sukuk;* These two objectives are addressed in Chapter 3 and Chapter 7 that attempted to answer the following question: (v) What are the main legal risks faced by these *sukuk* structures?

Objective 7: to critically examine the legal, regulative, *Shari'ah* and *Shari'ah* Supervisory Board related risks in the case of SABIC *sukuk*. In responding to this objective, Chapters 6, 7 and 8 provided the main recommendations, which addressed the following research question; what have been the consequences of *Shari'ah* and legal risks faced by Saudi *sukuk* structures?

1.3.2 Structural Design of the Research

It is important to state that due to the nature of the research, three main empirical chapters (Chapter 5, Chapter 6 and Chapter 7) have been developed following two literature review chapters (Chapter 2 and Chapter 3).

This thesis, therefore, represents a hybrid thesis structure, as in addition to empirical chapters as independent essays; there are two literature review chapters for providing a foundation. Each of the empirical essays provides its own particular literature review on the specific aspect of the theme discussed in the respective chapter, followed by empirical analysis and concludes by critical reflections. Thus, three of the empirical chapters have been developed as full individual papers, which, as a design

strategy, facilitated a better presentation of the identified individual arguments in an efficient manner.

It should be noted that a general Research Methodology is presented in Chapter 4, which has implications for each of the essays.

1.4 RATIONALE AND MOTIVATION

In the last few years, Islamic finance has developed significantly despite all the domestic and international; challenges as well as competitions with conventional finance sector. With such unprecedented developments, Islamic investment instruments have become more attractive for many investors, whether individuals, companies or governments because of its compliance with the *Shari'ah* law. The success of *sukuk* in the capital markets in many Muslim countries such as Malaysia and Bahrain has led many investors as individuals or companies in Saudi Arabia to invest their money via *sukuk*.

This study, hence, focuses on *sukuk* in a response to the increasing use and popularity of *sukuk* as an asset class and investment tool. However, the attractiveness of *sukuk* in the international financial markets as evidenced from the large number of issuances in the last decade in different countries is one of important reasons to study *sukuk* in this research. This is further substantiated by the successful performance of *sukuk* in short period to compete with conventional instruments, which are forbidden in *Shari'ah*. Despite the impact of the crisis, the capacity of *sukuk* to return to pre-crisis issuance levels in 2014 with total global *sukuk* issuance amounting to just over USD 120,854 million at the end of 2014 has shown that it is an asset class, which has proved its resilience, sources of which should be studied through academic rigour.

It should also be stated that there is not enough literature in the field of *sukuk* with the urgent need for the existence of these studies especially for the Saudi Arabian case, where the largest number of issuances have taken place.

An important motivation has been the impact of the financial crisis, which has had consequences of *sukuk* market, as the default observed in the GCC region, namely in Dubai. This clearly identifies that *sukuk*, despite its identified salient features being asset backed, for instance, has some *Shari'ah* and legal risks exposures. Therefore, in

order to locate the sources of these risk exposures and the sources of failures in relation to risk management, this research should be considered as a welcome contribution.

It should also be noted that as even before the financial crisis, a number of sceptical voices raised on the *Shari'ah* based nature of *sukuk*; indicating the legal risks associated with it. Thus, a rigorous research needed to examine and explore such issues, as aimed by this study.

1.5 SIGNIFICANCE OF THE RESEARCH

Since mid-20th century, there has been an increasing interest in research in relation to interest-free banks or IBF, which has seen a significant increase in the recent years. Over the past few years, Islamic finance has become a prominent competitor in the global financial markets. The success of Islamic financial institutions in the world markets has led many researchers to pay attention to this new paradigm.

Among the Islamic financing tools, *sukuk* are considered as one of the most important Islamic finance investment tool. The significance of this research is to contribute something new to the existing literature with regard to the risk issues related to *sukuk* within Islamic finance sector, which have not been studied extensively. This research, hence, is part of this emerging academic attempt in understanding the nature of *sukuk* with its legal, *Shari'ah* and regulative dimensions and the risks exposures.

Equally important is the fact that this study throws new light and makes suggestions on *Shari'ah* and legal issues concerning issuance of *sukuk* and securitization in Saudi Arabia, a country that as of present does not have any special laws regarding Islamic finance in general. Furthermore, researching *sukuk* is still very rare and therefore it is hoped that this research could be useful for Islamic financial institutions, investors and governments. This research could also be helpful in decision making and policy formulation.

The contribution of this research stems from three main areas which can be summarised in the following points, which also explains and articulates the methods through which contributions have been achieved in these three main areas:

(i) Contributions in exploring Shari'ah risks associated with the structure of SABIC sukuk

This research also contributed in identifying and discussing the most significant risks to which *sukuk* structure in general and SABIC *sukuk* in particular might be exposed through the following approach:

(a) Reviewing the previous research studies

In this regard, this research tends to explore the most significant *Shari'ah* issues associated with *sukuk* structures that have been argued and discussed in the previous research studies. These critical issues will be presented to SBSS in order to understand their opinions.

(b) Interviewing the members of SBSS

As has already been mentioned above, the interview was conducted with members of the SBSS to explore their opinion in relation to *sukuk* in general and SABIC *sukuk* in particular, which is considered as a major contribution provided by this research. Accordingly, the members of SBSS will be interviewed to explore their views regarding the structure of SABIC *sukuk* that has been approved by them in order to understand the most significant problems in terms of *Shari'ah* to which SABIC *sukuk* might have been exposed and that have already been discussed in previous research studies.

(c) Critical and analytical study of SABIC *sukuk* structure in terms of *Shari'ah*

This research should also be considered for its contribution in rendering a critical study on *Shari'ah* risks for the Saudi Arabian *sukuk* namely SABIC *sukuk*, whose structure was approved by most prominent scholars of Islamic finance particularly in Saudi Arabia.

In this regard, the main contribution of this study is the empirical analysis of the *sukuk* issuances in Saudi Arabia and the examination of their *Shari'ah* compliance . Particularly, the framework developed to examine the *Shari'ah* compliance of the SABIC *sukuk* represents another contribution with regard to the originality of this research. Furthermore, there is not much research conducted to deconstruct the

current *sukuk* structures and the related Islamic financial contracts. It should be noted that this research contributes to the current efforts to develop and improve knowledge and perceptions on the existing state of Islamic finance instruments generally and *sukuk* structures specifically and the compliance of both with *Shari'ah*.

Hence, this study is anticipated to provide as a reference for people whether individual *Shari'ah* scholars, *Shari'ah* supervisory board members or researchers seeking to understand how *sukuk* structures and related contracts are structured and how can the necessities and principles of *Shari'ah* be implemented and realised in practice. Importantly, they will understand as to how particular risks emerge in *sukuk* cases by examining the finding on SABIC *sukuk* related explored risk issues. Therefore, the empirical findings will be beneficial to the decision makers of the Islamic banks and institutions as to have a clear perceptions and understanding of the existing status of *sukuk* structures.

(ii) Contributions in exploring legal risks associated with the structure of SABIC sukuk:

Identifying the legal risks to which SABIC *sukuk* have been exposed is also deemed as an important contribution made by this study through the following approaches;

(a) Reviewing the previous research studies

These researches also explored and render a critical discussion on the most important issue presented by previous literature review featuring the legal risks to which *sukuk* structures might be exposed including SABIC *sukuk*.

(b) Interviewing the legal expert in *sukuk* and *sukuk* market

In exploring the legal risks were faced by SABIC *sukuk*, this study presented the opinion of the top three persons representing bodies related to *sukuk*, namely Capital Market Authority (CMA), the *Shari'ah* court and one of the legal specialists in *sukuk*. Those specialised interviews tend to identify and explore the most significant legal risks in relation to *sukuk* issued in Saudi Arabia.

The most important contribution in this study is that it has determined an evaluation and examination benchmark standard points in relation to *Shari'ah* and legal risks

associated with *sukuk* structure. Thus, by considering such risks in SABIC *sukuk* structures, and also other *sukuk* structures, one could manage to understand, examine and evaluate the most *Shari'ah* and legal risks.

(iii) Contributions in exploring the risk associated with SSB

This research provides benchmark standard points featuring the most important risks associated with *Shari'ah* boards. In other words, this study attempted to raise the awareness of those involved in *sukuk* particularly the members of *Shari'ah* boards, decision makers of banks and Islamic institutions and investors with regard to the risks associated with SSB. These are through the following ways:

(a) Reviewing the previous research studies

This research contributes to the relevant literature by identifying the most important risks stemming from SSB through reviewing the previous literature review. Those risks could be associated with a clear understanding of the exact role of SSB or otherwise the nonexistence of international standards issued by trustworthy organisations that make those standards binding to SSB in terms of commitment to those standards in relation to the approval of *sukuk*. Furthermore, by reviewing the previous studies, this research explored the risks that might be associated with the failure of the members of SSB to play their role in relation to the approval of the products of Islamic financing in general and *sukuk* in particular.

(b) Interviewing those concerned with Islamic *sukuk*

Another contribution is that this study attempted to review and discuss the views of *Shari'ah* scholars, academics and judges in Saudi Arabia as well as *Shari'ah* scholars as members of SSB who were in charge of approving the Islamic financial instruments particularly *sukuk* that have been issued in Saudi Arabia. Such primary data and its critical analysis shed a great deal of light on the identified risk issues by people who have involved in SABIC *sukuk* issuance at first hand. In addition, this research contributes through the analysis of the interviews to understand the main risks emerged as a result of failure of SSB to fulfil their expected role in relation to the approval of *sukuk* structures.

(c) Interviewing the members of *Shari'ah* board of SABIC *sukuk* (SBSS)

Given the fact that this study focused on a specific case study featuring SABIC *sukuk*, another contribution of this research relates to the interviews involving the members of *Shari'ah* board that approved SABIC *sukuk*, which is made up of three members considered the most prominent *Shari'ah* scholars in Islamic finance not only in Saudi Arabia but in the world as a whole. Having the opinions of such *Shari'ah* scholars through first-hand experience renders this research as original. In other words, those interviews definitely contributed to the understanding of the views of the most important three experts in Islamic finance in Saudi Arabia regarding the nature of their work in relation to the approval of SABIC *sukuk* and other matters associated with that SSB.

1.6 RESEARCH METHODOLOGY

While a detailed Research Methodology is provided in Chapter 4, this section presents a short section. In responding to the aims, objectives and the research questions, this research utilised qualitative and descriptive research methods. Through qualitative research method, interview schedule is utilised to gather data relating to risks aspects of *sukuk*. In this, professional lawyers as well as financiers but also *Shari'ah* scholars were interviewed to benefit from their knowledge and experience so that the responses can be developed for the identified research questions. Such primary data constitutes the main substance of the research in this study.

In addition, SABIC *sukuk* was taken as a case study. Therefore, an attempt was made to examine their structures and the relevant documentation (including legal/*shari'ah* documents) to identify the potential risk areas through descriptive documentation analysis of the paperwork of the structures.

As a data examination method, this study uses analytical critique method to examine the existing *sukuk* structures and legislations as well as the relevant documents of the SABIC *sukuk*.

1.7 OVERVIEW OF THE RESEARCH

This research is completed with eight chapters, which can be summarised as follows:

After this introductory chapter, *Chapter 2* highlights an introduction to *sukuk* and *sukuk* structures with regard to the conception definition of *sukuk*, *sukuk* types, basic structure of existing *sukuk*, AAOIFI`s ruling in relation to *sukuk*, issues in *sukuk*, critical perspective, trends and developments in the global *sukuk* market.

Chapter 3 outlines the Islamic capital market and *sukuk* in Saudi Arabia and evaluates the *sukuk* market in Saudi Arabia. Additionally, the legal and regulative environment and institutions for *sukuk* in Saudi Arabia are identified.

Chapter 4 describes the research methodology. In this chapter qualitative and descriptive research method aspects are explored through research methodology, research design, research strategy, and data collection and data analysis methods.

Chapter 5 introduces the main risks associated with *Shari'ah* supervisory boards. This chapter is divided into four sections, as the first one will highlight the importance of the *Shari'ah* supervisory board and the risks associated. The second part presents the primary data collected through interview survey from the field with the specialists in *sukuk* structures with regard to the significance of SSB by using a thematic analysis. The third section presents the primary data collected through interview survey from the field with the *Shari'ah* board members who were in charge of approving SABIC *sukuk* (SBSS) regarding their duty in approving and structuring SABIC *sukuk* as well as related issues. The last part of this chapter discusses and explores the risks which SABIC *sukuk* could be exposed from the time of issuing till the maturity.

Chapter 6 explores the main *Shari'ah* risks in relation to *sukuk* structures in general and SABIC *sukuk* in specific. The first part discusses and explores the critical issues associated with *Shari'ah* non-compliance risks, while the second section reports and discusses the position of the SBSS, particularly with regard to the issues related to the structure of SABIC *sukuk*. The third section discusses and examines the SABIC *sukuk* structure and the related documents from *Shari'ah* perspective to identify *Shari'ah* risks. Interview data were critically utilised to respond to the research questions identified in this research.

Chapter 7 explores and examines the main legal risks associated with *sukuk* structures issued in Saudi Arabia. This chapter is divided into three sections; section one explores the legal risks that *sukuk* structures might be exposed to. In addition, the

risks related to the *sukuk* holders, sales of assets, default, bankruptcy *etc.* are highlighted and identified. Section two provides a critical understanding of the identified issues in the SABIC *sukuk*, through the interviews were conducted with those who are specialised in the legal side of Islamic finance especially *sukuk* such as lawyers, judges of *Shari'ah* courts, researchers and academic staff. The third part of this chapter attempted to explore and identify the legal risks related to SABIC *sukuk.*

Chapter 8 presents the conclusion of the research by summarizing the findings and highlighting the most important results in the research. As well as the recommendations, future research and the epilogue is provided at the end of the chapter.

Chapter 2

AN INTRODUCTION TO ISLAMIC FINANCE AND *SUKUK*

2.1 INTRODUCTION

Islamic banking and finance (IBF) sector has become one of the fastest growing sectors in the world as well as it has received great acceptance by both Muslim countries and non-Muslim countries. While initially developments in the sector has been around commercial banking, in the recent years, developments of Islamic financial and Islamic capital markets have shifted the development trajectory of Islamic finance towards more sophisticated institutions, operations and transactions.

In this regard, *sukuk* can be considered as one of the most popular Islamic financial *instruments. This chapter aims to provide an overview of Islamic financial principles* and then will focus on *sukuk* with its aspects, definition and types before concluding the chapter with the global developments and trends in relations to *sukuk.* In addition, the types as well as the structures of investment *sukuk* and the AAOIFI'S ruling in relation to *sukuk* are also discussed.

2.2 THE EMERGENCE OF ISLAMIC FINANCE

Since the mid-20th century a group of Muslim scholars from various countries endeavoured to reformulate the financial instruments historically used by of Muslims in their trading activities (Warde, 2000). However, those scholars had to take the initiative to develop an alternative financial system with an authentic understanding of Islamic teaching, while *Shari'ah* rules have been re-interpreted to open new outlets for investment to cope with the significant advance in the Western financial systems. Consequently, the old financial instruments have been re-invented according to *Shari'ah* rules such as excluding *riba* or interest and *gharar* or uncertainty to ensure *Shari'ah* compliancy (Usmani, 2002).

The idea of IBF is considered part and parcel of the concept of Islamic moral economy (IME), which features a set of divine and moral rules that control economic activities and financial transactions so that the overall social good can be achieved (Asutay, 2010). It should be mentioned that Islamic financing is shaped by *fiqh* in the form of Islamic *Shari'ah* in fulfilling form requirement, as *Shari'ah* always

constitutes the reference for Muslims with regard to financial transactions (McMillen, 2001). In addition, it is shaped by Islamic morality in providing the moral underpinning. Thus, the concept of Islamic finance and economics should necessarily incorporate the norms and forms relevant to the Islamic doctrine (Wardiwiyono, 2013).

It can be noted that the failure of economic development programmes in the third world countries in general and the Muslim countries in particular have motivated the search for modernising the financial and economic institutions in the latter (Ayub, 2009). Thus with the emergence of Islamic economics and finance, the main aim is to establish a Muslim approach in economic development as oppose to the western materialistic economic approach. In this regard, the capitalist and socialist systems are deemed as morally inadequate by Muslim standards (Asutay, 2010). Therefore, the emergence of Islamic finance and economics is related to the development list needs in the Muslim world. In addition, in the wake of public grievances featuring Muslim countries to explore new financial transactions that refrain from practices that do not comply with *Shari'ah*, the idea of Islamic banks has come into existence in mid-1970s (Ibrahim, 2007). With the idea of exploring new modes of Islamic financing as to help Muslim capable of investing their money or otherwise dealing with financial transactions without offending the *Shari'ah.*

The initial experience in modern times in Islamic banking was in 1963, when the idea of Islamic banks came into application through the establishment of a social bank in the town of *Mith Gamr* to the north of Cairo (Mayer, 1985), which was based on accepting deposits from individuals provided that those deposits meet the minimum amount defined by the bank. The bank then managed to invest those deposits directly or indirectly through experienced partners. At the end of every year, the bank distributed the profits or losses between account holders. In addition, the bank established a fund for mandatory charity (*zakat*) and social services (Sairally, 2007). Within one year of establishing the bank, the number of clients exceeded 18 thousand leading to the promotion of the idea all over the region. However, in mid-1967 traditional banks took control of this bank. The introduction of interest damaged the Islamic reputation of such Islamic social and saving banks (Siddiqi, 2006). That experience was followed by the establishment of Nasir Social Bank in 1971 in Egypt

under Law 66 of 1971 featuring the establishment of Nasir Social Bank Corporation with the objective of boosting social objective among the public, accepting deposits and providing help to those in need (Perry, 2011) on the condition that the bank should not be involved in interest-based transactions.

Another attempt in institutionalisation of Islamic finance came with Tabung Haji in 1967 in Malaysia in the form of saving association, which mainly aimed at investing the savings of potential pilgrims to enable them to undertake their pilgrimage with full financial confidence (Sairally, 2007).

It should be stated that the establishment of the IDB in 1974 was a landmark achievement of the Organisation of Islamic Conference (OIC) (or Organisation for Islamic Co-operation as it is known), which is considered as the 'World Bank' version for the Muslim world. In October 1974, the bank was established in Saudi Arabia based in Jeddah, and eventually started its activities in October 1976 with a subscribed capital of USD750 million. The main aim of the Islamic Development Bank was to encourage socio-economic progress for the people of member countries and Muslim communities at large in accordance with *Shari'ah* principles (Usmani, 1998; Warde, 2000), which also took the task of developing Islamic banking and finance.

Apart from the fully Islamised banking system of Iran in the post 1979 period, initial experiment in Islamic commercial banking came with Dubai Islamic Bank and the Kuwaiti Finance House in 1974 and 1977, respectively (Wilson, 2009). In addition, the first international conference in Islamic Economics was held in the Holy city of *Makkah* in 1976 under the auspices of King Abdul Aziz University. It should be mentioned that the conference was considered the first scientific conference bringing together researchers concerned with issues pertaining to the Islamic economy including Islamic banks (El-Gamal, 2006).

Furthermore, Faisal Islamic Bank was established in Sudan on April 1977 to serve the community there in accordance with the principles of *Shari'ah*. In the same year, Faisal Islamic Bank of Egypt was established, followed by the establishment of the International Islamic Bank for Investment and Development in 1979. Then afterwards, commercial banks started to establish branches with Islamic labels.

Starting from 1985 onwards, Pakistan began a program to incorporate its banking system into the Islamic system in the aftermath of the execution of a five-year-plan (Khan and Bhatti, 2008; Visser, 2013).

It is important to note that the growth of IBFs in terms of finances and asset base has been unprecedented since the 1990s: there were 176 IBFs in 1997 (Algaoud and Lewis, 2007), which increased to 261 in 2006 according to Boudjelal (2006). By 2015, the number rose to over 500 institutions operating in 75 countries (The Banker, 2015). During this period, the growth in the asset size of Islamic financial institutions has been unprecedented as well; as despite the political, legal and regulative hindrances in each of the countries in which they exists, the Islamic banking asset base has reached over USD 2 trillion by 2015 with double digit annual growth rates (The Banker, 2015).

The advance of the Islamic banking industry and its expansion in the Muslim world has drawn the attention of some countries in Europe and America to the experiment of Islamic finance as an alternative for traditional financing particularly for Muslim minorities. In fact, the Islamic banking business has become a main focus of attention around the world as the assets of Islamic banks are becoming so huge compared with the short duration of the experiment (Ahmed, 2011). In particular in the aftermath of global financial crisis during 2007-2009, the success of Islamic finance with its observed resilience against the crisis increased the demand from non-Muslim quarters towards Islamic finance. This process encouraged Western countries particularly the United Kingdom (UK) to develop *Shari'ah* compliant financial environment to attract capital from Muslim countries particularly from the GCC countries. Secondly, they have been motivated to satisfy the desires of the Muslim communities in those countries as to comply with *Shari'ah* law in terms of financial transactions whereby increasing the financial inclusion by overcoming religious exclusion in financial activities. With such motivations, IBF started to operate in Europe as early as the 1980s; however, European banks have been operating in the Middle East since the 1920s (Wilson, 2008; Ahmed, 2009).

According to Ayub (2009) Islamic financial institutions have been recognized and their credibility has been witnessed across the world with the assistance of global bodies such as AAOIFI, the Islamic Financial Services Board (IFSB), the

international Islamic financial market (IIFM) and the Liquidity Management Centre (LMC).

However, despite the significant achievement made by IBF over the last 40 years and yet in the wake of the wave of globalization, the beset the world in the 1990s IBF has compromised its Islamic identity in favour of traditional commercial banking (Iqbal and Molyneux, 2005; Asutay, 2007). Thus, in order to cope with the traditional system of finance, efficiency and profitability rather than social justice has become the main focus of IBF (Asutay, 2012). In doing so, IBF has become part and parcel of the global financial system leaving aside its Islamic values. In other words, IBF no longer provides an alternative for the conventional system, but instead operates as a component of that system (Asutay, 2007).

2.3 THE CONCEPTION OF ISLAMIC FINANCE

The Islamic system of finance provides a potential alternative to the conventional financial system, not only for Muslim countries but also for the rest of the world (Iqbal, 1997). The interest-free Islamic banking is based on prohibition of *riba* (interest), which constitutes one of the main features of the concept of IBF (Saeed, 1996). However, the exact definition of the term *riba* has been a matter for debate among Islamic scholars, and yet the majority of Muslims believe that all interest-based transactions should be considered as *riba* (Ahmad and Hassan, 2007). Nonetheless, some scholars such as Mohammed Sayyed Altantantawi, who used to be Sheikh of Al-Azhar, one of the oldest Islamic learning institutions in the world, argued that a reasonable interest rate would be allowed in Islam (Warde, 2000), which, however, as a position, has not gained any momentum.

In an attempt to provide a definition, it can be stated that any financial practice consistent with *Shari'ah* law should be described as Islamic finance (Tayyebi, 2008). In this regard, Islam has its own code of moral practice in business that makes the Muslim societies take their place among civilised societies (Ayub, 2009).

The concept of Islamic finance is mainly based on the idea of refraining *riba* or interest-based transactions as well as avoiding all practices that could be ambiguous or risk-taking such as speculation (Algaoud and Lewis, 2007). In this respect,

Muslims are encouraged to make their earnings through permissible means (*halal*) yearning for social justice as their main goal (El-Gamal, 2000).

In shaping the principles of Islamic finance, *Qur'an* and the traditions of the Prophet Mohammed (pbuh) remain the main ontological sources. The moral and legal principles driven from these sources along with historical and classical sources of Islam tend to make a clear distinction between those institutions and conventional financial institutions. However, the definition of Islamic finance should go beyond the prohibition of *riba* to include all controversial business activity that could be socially and ethically unacceptable according to Islamic standards (Warde, 2000; Asutay, 2007, 2012).

In relation to the main principles of Islamic finance, risk sharing remains an important distinguishing nature of Islamic finance in the sense that all the parties involved in the financial transaction should equally share any potential risk (Ahmed and Khan, 2007; Ahmed, 2010). This is not the case with traditional financing where the borrower takes all the risk while the lender is guaranteed to receive a pre-determined profit on top of the sum he has given away (Iqbal and Mirakhor, 2011). Therefore, this is a kind of exploitation of one party to another which is socially and ethically unacceptable, whereas profit and loss sharing would be a fair deal for both parties (Iqbal, 1997; Asutay, 2008). Thus, as a natural consequence of risk sharing, profit-and-loss sharing constitutes the second main operational nature of Islamic finance. Thirdly, social development should be the top priority for individuals as well as financial institution through giving charity and paying *zakat* (mandatory charity) to the needy and the less fortunate as well as Islamic finance goes beyond simple transactions and banking services to include other services such as: security firms, insurance companies and mutual funds (Warde, 2000). Therefore, through Islamic finance, Islamic economic principles would be put into practice (Visser, 2013) by developing a socially and financial optimal outcome in the process.

Islamic social accountability in the form of 'hereafter' helps Muslim individuals to shape their financial behaviour along with in other spheres. Thus, Muslims should always bear in mind that they cannot escape the divine justice, and that should make them avoid all malpractices in their business dealings. This implies that people should do their business dealings with all the due wisdom and respect of one another, and

should help others for the sake of Allah. Thus, Islamic ethical principle and moral articulations in everyday practice remain an important paradigm in shaping the nature of Islamic financing, which pays attention to the society at large as to avoid greed and social injustice (Asutay, 2007; Iqbal and Mirakhor, 2011).

2.4 ISLAMIC FINANCING PRINCIPLES

Islamic finance features any business practice based on the principles of *Shari'ah* or more precisely consistent with the rules of Islamic commercial jurisprudence (Usmani, 2002). However, it should be noted that business transactions and practices that are socially and ethically unacceptable according to Islamic standards are considered prohibited as prescribed by *Shari'ah.* The prohibited practices include interest (*riba*), uncertain transactions (*gharar*), and gambling (*maysir* or *qimar*). In the meantime, Islam encourages individuals to practice trade with all the due honesty and credibility (El-Gamal, 2006). In addition, financial transactions should also consider positively contributing to social good and human well-being as established by *maqasid al-Shari'ah* (Ahmed, 2009;Dusuki and Bouheraoua, 2011). These principles are discussed in the following sections:

The Prohibition of Riba

The first major principles of Islamic finance is that the prohibition of *riba* or interest. Muslims unanimously agree that *riba* is considered as a major sin in Islam as well as any kind of financial transactions involved *riba* is impermissible (Iqbal and Mirakhor, 2011). In this regard, Ayub (2009) defines the word *riba* as unlawful gain as opposed to profit from sale. Therefore, the word *riba* literally means 'excess', referring to any increase in capital through giving loans to others or any other interest-based deal and transactions (Iqbal, 1997).

In this respect, according to Archer and Abdel Karim (2002), *Shari'ah* rejects interest-based business transactions as morally unacceptable amounting to the exploitation of one party to another. In other words, Islam considers a return or rent on money is immoral and unfair (El-Gamal, 2006). In addition to considered as morally and socially unlawful, *riba* prohibition is also rationalized on the ground of economic rationality in terms of economic stability (Chapra and Khan, 2000).

The Islamic solution for overcoming *riba* has been through focusing on real economy embedded financial transactions. Accordingly, money should be invested through the purchase and sale of tangible assets, and income streams should be derived from the economic use of those assets (Usmani, 2002).

According to Iqbal and Tsubota (2008), the prohibition of *riba* should not be confused with other business returns on capital. Moreover, Islam always encourages people to work and become actively involved in business provided that the business does not *harm* or offend others as this is not the case with *riba* where one party is offended and exploited by the other.

In terms of developing the embedded economy in overcoming interest, the 'profit-and-loss sharing' and 'risk sharing' type of financing is considered (Archer and Abdel Karim, 2002; DeLorenzo, 2006). Such principles aims at developing real economy based financing in the sense that financing is embedded in the real economy and Islamic norms. This should imply that money does not produce money without effort or taking risks (Asyraf, 2011). This should make a clear distinction between profit from sales and interest from loans (Vogel and Hayes, 1998). In aiming to overcome the interest and its impact, it should be noted that IME does not allow money to be generated via the credit scheme, as money is considered not having any intrinsic value (Iqbal, 1997).

Prohibition of Gharar

Gharar is the second major prohibition in the principles of Islamic finance, which involves an uncertain or risky deal as the deal is made for a future product which could or could not materialize (Ayub, 2009). Therefore, any deal involving *gharar* is prohibited by *Shari'ah*.

Literally, *gharar* means risk or uncertainty (Iqbal and Llewellyn, 2002). According to El-Gamal, (2001) *gharar* involves the sale of items whose existence is uncertain or doubtful. For this reason, *gharar* deals amount to gambling, which is prohibited by *Shari'ah.* Some examples of *gharar* include selling fish in the water, a calf in the womb, birds in the air, a runaway animal, un-ripened fruits on trees, a crop before harvest, *etc*. In all of the above cases, the sold item is uncertain which makes the trade a gamble (Ahmad and Marhaini, 2008). It should be noted that there are two fields

where *gharar* strongly affects common practice in contemporary financial transactions: insurance and financial derivatives (Siddiqui, 2008).

According to jurists, three types of *gharar* are identified: major or excessive *gharar*, minor *gharar* and the third type is in the grey area between the two other types (Aldarer, 1993). Accordingly, involvement in excessive *gharar* should invalidate the contract unless there is a public needs such as *salam* contract, while the minor one could be tolerated (Al-saati, 2003; Ahmed, 2011; Lahsasna, 2013). It should be mentioned that since any transaction cannot be entirely *gharar*-free, the validity or otherwise invalidity of any contract or transaction could be variable depending upon the level of uncertainty (Al-Suwailem, 1999). Nonetheless, scholars have put three conditions for invalidating a transaction or contract as *gharar*. Firstly, there must be a clear evidence that the contract or transaction belongs to excessive *gharar* category. Secondly, the subject of the contract or transaction must be commutative financial contract-like sale. Thirdly, the subject of dispute must be the principle component of the sale such as the case with an unborn calf as the parties involved have no idea whether the infant will be born alive or dead (Al-Suwailem, 1999; Al-saati, 2003; El-Gamal, 2006).

It should be noted that the rationale behind the prohibition of *gharar* is that such transactions could become a cause of potential disputes between the parties involved and could possibly disrupt social peace (Ayub, 2009).

Prohibition of Gambling (Maisir-Qimar)

In cases where gambling (*maisir* or *qimar*) is involved, one can earn easy money without making any effort (El-Gamal, 2000), which implies that big gain is simply made at the expense of others who are unfortunate. The only requirement for gambling is the extent to which a gambler is prepared to take risks (Vogel and Hayes, 1998). In other words, the gambler usually risks a small amount of money to earn huge amounts in no time provided that luck plays in his favour, with the possibility that he might lose. In this sense, gambling in Islam is deemed as a sort of *gharar* as the gambler relies on luck and nothing else, *i.e.* either wins it all or loses it all (Ayub, 2009). However, it becomes obvious that gambling is prohibited in Islam as it tends to provide a chance for the gambler to make his fortune at the expense of others

without making any effort (Chapra, 2009). It should be noted that some perceive gambling as a form of *gharar* featuring the sale of items whose existence is uncertain and specifications unclear, which casts doubts on the validity of the transaction (Zahraa and Mahmor, 2002).

2.5 ISLAMIC FINANCING INSTRUMENTS

Over the centuries, a number of Islamic financing products have been developed and used in different parts of the world. These can be classified into three main categories: 'profit and loss sharing contracts' or PLS; 'debt-based contracts'; and 'others. In the first group *mudarabah* and *musharakah* can be considered, *murabahah*, *ijarah* and other debt oriented financial contracts classified under the second group; and the third group cover the instruments which are not the main financing instruments such as *quard-al-hassan.*

2.5.1 PLS Based Modes of Financing

(i) Mudarabah

According to El-Gamal (2006), the high potential of Islamic financial industry is greatly a function of the model of *mudarabah* (silent partnership) due to its embedded nature of financing. Therefore, it is a venture capital type of financing, which, as Islamic moral economy articulates, it is the best solution to financing problem. Thus, *mudarabah* features a business partnership (*shirkah*) between a company and an agent in which case the former provides money for investment by the latter. The profit is to be shared in accordance with agreed terms, whereas the loss is to be borne by the provider of capital as long as the terms of partnership are being met by the agent (Siddiqi, 1985). However, the agreement should not refer to fixed profits or percentages to be returned to the provider otherwise it will be a form of usury (*riba*), which is prohibited in Islam (Ahmed, 2015).

The fact that a contract involving *mudarabah* gives the two parties the right to withdraw from the agreement at any time on reasonable notice, could create serious problems in modern commercial enterprises. In case of *mudarabah,* however, profit can only be distributed after clearing all liabilities and commitments (Iqbal and Molyneux, 2005). In this regard, the basic principles of *mudarabah* have been

highlighted by (Siddiqi, 1983; El-Husseini, 1988; Usmani, 2002; DIFC, 2009) as follows;

(i) The process of financing in relation to *mudarabah* should not mean advancing of money;

(ii) The provider should be ready to bear the losses or otherwise share those losses with the agent in accordance with the contract;

(iii) Allocation of profit is a matter of agreement between the parties involved, and yet the distribution of profits should take into account the efforts made by each of those parties;

It should be noted that *mudarabah* is not a popularly utilised Islamic financing mode in the contemporary world; due to the agency problem, moral hazard and adverse selection related issues (Kahf and Khan, 1992; Ahmed, 2002), despite the fact it is one of the most essentialised moral economy oriented Islamic financing method.

(ii) Musharakah

Musharakah involves a contract between two or more parties to establish a business, whereby all parties will make contribution in terms of labour and capital (Usmani, 1999). Consequently, the profits will be shared by the partners involved on an agreed basis, while the sharing of losses will be in proportion of capital contribution (Iqbal and Llewellyn, 2002). Nonetheless, fixation of sum lump profits will not be allowed by *Shari'ah* (Iqbal and Molyneux, 2005).

It should be noted that *musharakah* provides a real alternative for interest-based financing operations undertaken by traditional banking institutions (Khan and Mirakhor, 1989). In this regard, it constitutes one of the main methods of financing in accordance with Islamic principles (Usmani, 2002). Accordingly, businesses involving *musharakah* should avoid activities that are prohibited by *Shari'ah* such as selling alcohol products, pork, drugs, gambling, *etc*. In this respect, syndicates featuring Islamic and conventional banks should feature contracts taking *Shari'ah* into account. Nevertheless, the majority of jurists are of the opinion that in case of

partnership the value of assets involved should be specific beyond doubt (Usmani, 2002).

(iii) Muzara'ah

This is an agricultural contract where one party provides the land for cultivation and the output is shared between the parties involved (Kahf and Khan, 1992). In this contract, the land plot and the period of the agreement must be specified (Rahman, and Othman, 2012). However, generally speaking *muzara'ah* and *mudarabah* both seem to resemble one another with a difference (Shaikh, 2013). In practice, *muzara'ah* contract is considered another version of *mudarabah* in the area of farming (Iqbal and Mirakhor, 2011).

(iv) Musaqat

Musaqat contract involves the sharing of arable land provided by one party, while the other party provides the labour (Ahmed, 1990). However, both parties contribute towards costs including fertilisers' seeds, pesticides, machinery, *etc*. (Kahf, 1992). In this method of financing, the production is distributed between the two parties in accordance with an agreed-upon ratio (Iqbal and Molyneux, 2005). In addition, the bank could be also the provider of orchard and gardens which he owns or otherwise in his possession (Ahmed, 1990). The harvest which may be fruits, flowers, leaves, *etc*. could be shared in accordance with a ratio stipulated by the agreement (Ahmed, 1993).

In fact, *musaqat* is a form of *musharakah* involving a garden or orchard, which belongs to one party. The other party provides labour with respect to farming duties and the harvest is shared between the two parties in accordance with an agreed-upon ratio (Kahf and Khan, 1992). Therefore, in *musaqat*, a fixed asset featuring a land with trees in put at the disposal of a working partner without paying for it. Thus, instead of financing, one partner only provides the asset. However, in both *musaqat* and *muzara'ah*, the output is shared and the contract should show flexibility with regards to the distribution of operational costs (Kahf and Khan, 1992).

2.5.2 Sale based Products

(i) Murabahah

Murabahah constitutes one of several business contracts that are becoming increasingly popular among Islamic financial institutions (Ahmed, 1993). Moreover, contracts involving *murabahah* could be modified as a means of extending credit without the need for the principle of interest-based loans, which is prohibited by *Shari'ah* (Usmani, 1998). However, *murabahah* could be used by Islamic banks to finance businesses involving raw materials, machinery, consumer goods *etc*. (Khoja, 1995).

The term *murabahah* originates from the Arabic word '*ribh*', which means profit, gain or addition (Hamzah *et. al,* 2014). According to Ayub (2009), *murabahah* implies that the cost of the commodity needs to be known so that an agreed margin of profit can be decided. As far as Islam is concerned, *murabahah* is considered a lawful transaction, and yet the practice has its own limitations.

In medieval ages, however, *murabahah per se*' was deemed as a mode of trade rather than a method of financing (Ayub, 2012). However, despite the associated limitations, jurists of contemporary times accepted *murabahah* as an alternative for interest-based financing. In this regard, jurists argue that despite its limitations *murabahah* tend to protect the needy, the less skilful and inexperienced among purchasers against powerful and greedy businessmen. Nonetheless, as long as no reference in *Qur'an* or *Sunnah* that clearly prohibit the practice exists, then it can be adopted subject to the conditions set by jurists and scholars. Accordingly, *murabahah* has been allowed as an alternative of interest-based transactions, which are not compatible with *Shari'ah* principles (Hussain, 2012).

It is noteworthy that for *murabahah* transactions to be valid two discrete contracts should be considered by the bank involved: a purchase contract and selling contract featuring the subject commodity (Ayub, 2009). Additionally, the selling contract should include detailed specifications of the commodity in terms of price and delivery time schedule as well as the methods of payment so that those specifications should not be changed in case of default.

Being the mark-up type of financial contract, *murabahah* is the most popular instrument used by Islamic banking and finance in the contemporary world as when it is compared to the PLS modes it is less risky (Tariq and Dar, 2007; Ahmed, 2002).

(ii) Ijarah

'*Ijarah*' *per se* is not considered a mode of financing but rather a normal business sale activity. However, according to Usmani (2005), for one reason or another, most likely for reasons having to do with taxation, this kind of transaction is becoming popular in Western countries as a method of financing. Usmani (2005) states that *ijarah* can be best defined as a form of leasing where the usufruct of a particular property or service is transferred from the original owner to another person under a special contract or agreement.

According to Anwar (2003), two forms of lease contracts exist in relation to IF's investment, *i.e.* operational lease and financial lease. In case of the former, the usufruct of a particular asset, which could be machinery, trains, ships, cars *etc.* is sold to a lessee for a fixed price and a fixed duration of time. In most cases involving such leasing any unexpected breakdown would be the responsibility of the lessor, while regular maintenance of the leased item is the duty of the lessee. Subsequently, short periods of sudden breakdowns will increase the risk to be taken by the lessor. On the other hand, in case of finance lease, it involves a longer period of time favouring the lessor in terms of amortizing costs of the assets with profit and retaining relatively higher financial security. The lessee can buy the asset at the current market price when the contract terminates. However, finance lease can terminate at any time by the mutual consent of the parties involved. According to some scholars finance lease could be financially infeasible as it leaves the lessee far worse-off compared to interest-based financing which is not allowed by Islam (Ibrahim, 2007).

It should be noted that some key differences exist between *ijarah* and traditional leasing. To mention but a few of those differences is that the original owner has to take all risks in relation to the leased item at all times (Hanif, 2014). Moreover, at the end of the lease sale to the lessee is not a condition of the contract. The bank gains its profits from the profit charges on the cost of the leased asset and that profit is incurred with repayments of the lease. In terms of Islamic finance, the main significance of

ijarah is that it is not an interest-based transaction. For this reason, even though *ijarah* is not a mode of financing in the real sense of the word, it is widely used by Islamic banks to acquire assets for their clients. In certain countries *ijarah* could be useful for gaining tax concessions. However, whether or not transaction related to leasing can be used as a mode of financing in terms of *Shari'ah* depends on the terms and conditions of the contracts (Kamali, 2007).

(iii) *Salam*

Salam is a contract involving the purchase of specified goods to be delivered later for a prepaid price (Khoja and Abo Ghuddah, 1995). In other words, the quality, quantity and delivery time of the goods will be agreed upon in the contract between the two parties (Mohammed, 1988). It should be noted that *salam* is exactly the opposite of '*bai mu'ajjal*' or 'differed sale' whereby the goods will be delivered in advance for a late payment (Hanafi and Kasim, 2006). According to Ayub (2009), *bai mu'ajjal* could be described as being similar to an interest-free loan. However, *salam* contract nonetheless, is valid only in case of fungible commodities.

It should be noted that *salam* and *istisnaa* are considered free from *gharar* provided that the relevant conditions of each are being met (Paldi, 2014). Yet, both *istisnaa* and *salam* are deemed as forward sales as the delivery of goods in both cases takes place later in future (Usmani, 2002). Therefore, in terms of Islamic principles, a sale deal can be made whereby the subject item can be delivered in future as the case with *istisnaa* and *salam* sales (Ayub 2009).

(iv) ***Istisnaa***

In the case of *Istisnaa,* a deal is made featuring a commodity that does not physically exist (Usmani, 2005), which implies that the deal could be in the form of an order where a manufacturer has to produce a specific product for a purchaser. Therefore, in case of *istisnaa,* the manufacturer is committed to provide a product, while the purchaser has to pay nothing in advance. However, such sale contracts nonetheless, become valid only in cases where the two parties initially agree on the product in terms of price and specifications (Usmani, 2002).

It should be noted that *istisnaa* and *salam* contracts resemble each other in the sense that both are exceptional cases to the rule that prohibit selling something that is non-existent at the time the deal is being made (Iqbal and Molyneux, 2005). However, the main difference between the two is that *istisnaa* only involves goods to be manufactured, while *salam* contract can feature any type of goods to be manufactured or otherwise (El-Gamal, 2000). Furthermore, in case of *salam*, a full payment of the price is required, whereas in case of *istisnaa* payment can be made later (Zarqa, 1997). Finally, in terms of delivery time that must be specified in *salam* contracts, which is not necessarily the case in contracts involving *istisnaa* (Iqbal, 1999).

2.6 *SUKUK*: CONCEPTUAL DEFINITION AND AAOIFI STANDARDS RELATING TO *SUKUK*

Previous discussion presented the main principles of Islamic financing as well as the main Islamic financing instruments used in contemporary Islamic banking and finance industry. An important extension of Islamic financing since the beginning of this century has been the developments in Islamic capital and financial markets. In particular, for the need of long term and for infrastructure financing, Islamic capital markets have developed along the identified Islamic financing principles and instruments. *Sukuk* or as commonly known Islamic bond, being the main thrust of Islamic capital markets, has been singled out as a dynamic sphere of expansion of Islamic financial industry. Since this research is particularly focused on the legal and *Shari'ah* risks associated with *sukuk*, the following sections aim provide a conceptual definition and explain the working mechanism of *sukuk* with *sukuk* types and concludes with the developments and trends in *sukuk* markets.

According to Adam and Thomas (2004), the term *sukuk* presently used to describe Islamic bond is derived from the Arabic language and it is a plural of another Arabic word *sakk.* The term *sakk* is derived from striking one's seal on a document or tablet representing a contract or conveyance of rights, obligations and or monies (McMillen, 2006). As a modern concept in the corporate world, *sukuk* refers to a financial instrument that carries with it specific property rights and obligations including some form of asset ownership (Adam and Thomas, 2004).

In financial terms, *sukuk* are described as asset-backed certificates of participation securities which provide evidence of ownership of an asset or the right to its yield

(usufruct), entailing the granting to an investor of a share of an asset along with the cash flow and proportionate risk equal to the ownership or level of financial participation in the enterprise (Tariq, 2004).

The AAOIFI in its accounting standard describes *sukuk* as an investment product in order to delineate them from shares and bonds. It defines it as:

> certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of the *sukuk*, the closing of subscription and the employment of funds received for the purpose for which the *sukuk* were issued. (AAOIFI, 2010)

Equally, the AAOIFI standard goes on to distinguish investment *sukuk* from shares, notes and bonds, within the confine of the standard, as an instrument with an intrinsic value. The standard also emphasises that unlike other investment grade securities like shares and bonds, investment *sukuk* do not represent debts owed by the issuer or certificate holder and that such *sukuk* may not be issued with the intention for use for a pool of receivables. Finally, the standard notes that that the underlying business contract or arrangement for such *sukuk* must be consistent with Islamic principles represented by the *Shari'ah* (Adam and Thomas, 2004).

In another definition, *sukuk* are likened to entitlement scrip with each *sukuk* (scrip) representing a proportional ownership in an underlying asset or project, which may be an investment project like a motorway project, energy project, or a property development project or a collection of underlying assets (*e.g.* real assets like a factory's inventory or vehicles held under *ijarah* scheme of financial institutions) (Zohra and Javed, 2007). In other words, an item is bought or financed in such a manner that each investor invests a certain amount to its price and operations, and in turn becomes owner of the proportion contributed, by holding the *sukuk* scrip of that value.

It should be noted that *sukuk* are like stocks (shares) of a company, they represent ownership entitlement of assets and the returns on the *sukuk* ought to be based upon the returns from those underlying assets. However, the similarity ends there. Without tangible assets or rights of usage of the assets, there can be no *sukuk* (Yean, 2009). Unlike stocks (shares), *sukuk* in practice, usually do have a maturity period, and this

property brings them closer to bonds. Hence, *sukuk* can be defined also as 'equity bonds', while defeating and negating the primary definition of bonds being debt-based instruments (Jabeen, 2007).

It should be mentioned that *sukuk* represent a source of generating funds that is Islamically permissible based on Islamic finance rules represented by the *Shari'ah* and derives (should derive) its returns from the underlying assets they represent (Hassan and Shahid, 2010).

The *Shari'ah* board of AAOIFI (2008) has issued six recommendations with regard to proper *sukuk* structure, which are:

(i) For purposes of marketing, *sukuk* must be owned by the *sukuk* holders who retain legal right for ownership. In this regard, the task of the management should be confined to the transfer of *sukuk* ownership rather than keeping them as part of their assets;

(ii) Apart from cases where a financial institution is folding or otherwise dealing with an urgent financial obligation, *sukuk* must not feature receivables or debts;

(iii) Where *sukuk* are involved, managers are not allowed to offer loans to holders, unless they make sure that their actual earnings are in excess of their expected earnings. Yet, in some cases managers are allowed to establish a reserve investment in order to cover shortfalls as mentioned in the prospectus;

(iv) Managers, partners as well as investment agents should not re-purchase assets from *sukuk* holders at nominal value when their expiry date is due. Nonetheless, assets could possibly be purchased at their net value, market value, fair market value or for any price to be agreed upon at the time of purchase provided that the rules of *Shari'ah* in relation to partnership and subject of guarantees are taken into account;

(v) In cases where *ijarah sukuk* is involved, the lessee is allowed to purchase the leased assets when the *sukuk* expire in terms of nominal value. However, that should only happen on condition that the lessee is neither an investment partner nor is he an investment manager or agent.

(vi) Rather than limiting their role to issuing *fatawa* with regard to *sukuk* structure, *Shari'ah* supervisory boards should necessarily become concerned with implementation and compliance with the rules.

2.7 TYPES OF INVESTMENT *SUKUK*

After identifying the nature and definition of *sukuk* in the previous section, this section presents the types of *sukuk*.

As mentioned above, AAOIFI (2010) issued *Shari'ah* standards for different types of *sukuk*, the common types of investment *sukuk* in regard to the issuances and trading include *sukuk* of ownership of leased assets, ownership of usufructs, ownership of services, *murabahah*, *salam*, *istisnaa*, *mudarabah*, *musharakah*, investment agency and sharecropping, irrigation and agricultural partnerships; some of these are discussed in general in this section.

2.7.1 *Ijarah Sukuk*

According to AAOIFI (2010), the *ijarah sukuk* can be classified into two types, which include *sukuk* of ownership of leased assets and *sukuk* of ownership of usufructs (*manfa'ah*). The definition of each type can be included as follows;

Sukuk of ownership of leased assets

"These are certificates of equal value issued either by the owner of a leased asset or a tangible asset to be leased by promise, or they are issued by a financial intermediary acting on behalf of the owner with the aim of selling the asset and recovering its value through subscription so that the holders of the certificates become owners of the assets" (AAOIFI, 2010).

Sukuk of ownership of usufructs

This kind of *sukuk* structure can be classified into four types according to AAOIFI standards, which include;

(i) *Sukuk* of ownership of usufructs of existing assets

According to AAOIFI (2010) these are two types:

(a) "Certificates of equal value issued by the owner of an existing asset either on his own or through a financial intermediary, with the aim of leasing the asset and receiving the rental from the revenue of subscription so that the usufruct of the assets passes into the ownership of the holders of the certificates".

(b) "Certificates of equal value issued by the owner of the usufruct of an existing asset (lessee), either on his own or through a financial intermediary, with the aim of subleasing the usufruct and receiving the rental from the revenue of the subscription so that the holders of the certificates become owners of the usufruct of the asset".

(ii) *Sukuk* of ownership of usufructs of described future assets

"These are certificates of equal value issued for the purpose of leasing out tangible future assets and for collecting the rental from the subscription revenue so that the usufruct of the described future asset passes into the ownership of the holders of the certificates" (AAOIFI, 2010).

(iii) *Sukuk* of ownership of services of a specified party

"These are certificates of equal value issued for the purpose of providing services through a specified provider (such as educational benefits in a nominated university) and obtaining the service charges in the form of subscription income so that the holders of the certificates become owners of these services" (AAOIFI, 2010).

(iv) *Sukuk* of ownership of described future services

"These are certificates of equal value issued for the purpose of providing future services through described provider (such as educational benefits from a university without naming the educational institution) and obtaining the fee in the form of subscription income so that the holders of the certificates become owners of the services" (AAOIFI, 2010).

The most popular underlying asset of the *manfa'ah sukuk* structure used is the rights to the commercial activities, allowing for the intangibles assets to be used in the structure of *sukuk*. The *manfa'ah* structure can be used when the issuer does not have tangible assets or they do not want to utilise them in the *sukuk* structure. In this

regard, there are deferent examples of *manfa'ah* used as an asset include the rights of intellectual property, the vouchers of airtime which representing minutes of airtime as well as the future receivables as result of the marketing contracts (DIFC, 2009; Latham and Watkins, 2015).

It should be mentioned that the structure of *ijarah sukuk* is deemed by some as the basis of other structures, as the simplicity involved in this structure makes it compatible with *Shari'ah* as well as it is preferred and popular among *Shari'ah* scholars as the key contributing factors (Thomas, 2007). However, as far as the Islamic financial principles is concerned, the term '*ijarah*' involves the transfer of the usufruct of an asset or property from one person to another in return for rent or lease (Iqbal and Mirakhor, 2011). On the other hand, *ijarah sukuk* is a kind of securities defining the ownership of an asset associated with a specific lease contract so that the rent generated from hiring the asset becomes payable to the holders of the *sukuk*. Thus, securitising *ijarah sukuk* contracts constitutes a key element in solving problems in relation to liquidity management paving the way for the process of financing public sector projects in developing countries (Ayub, 2005).

However, the efficiency of the asset and the associated arrangements featuring in the contract are the key factors for *sukuk* structure as to generate good returns in favour of potential investors. The main advantage of *ijarah sukuk* structure is that it provides means for regular payments within the life span of the financial contract (Iqbal and Mirakhor, 2011). In addition, the flexibility of the structure with regard to tailoring a payment profile as well as readjusting methods of calculation to generate the anticipated profits is another advantage of this type of *sukuk.* Nonetheless, in terms of Muslim faith, the structure is widely accepted as being compatible with the spirit of *Shari'ah* Law (Ayub, 2007). Therefore, bearing in mind the above characteristics, *ijarah* becomes a very reliable structure for *sukuk.*

In case of *ijarah* rentals, the arrangement of payment has to be made irrespective of the usufruct of the asset by the lessee. In other words, it is at the discretion of the two parties involved in the contract to decide the commencement of the payment involving *ijarah*. Such a condition renders *ijarah* contracts more flexible to the advantage of both issuers and holders of *sukuk* (Ayub, 2005). According to Kahf

(1998), this could provide an alternative for interest-borrowing assets useable in the process of performing government are durable.

It should be noted that there are many features of *ijarah sukuk*, which are as follow (Ayub, 2005; Usmani, 2007; Merah, 2008; AAOIFI, 2010):

(i) Where *ijarah* contract is involved, the least asset as well as the amount should be clearly defined. In this regard, *ijarah* contracts could include things like buildings under construction as long as they are clearly defined in the contract. This is on condition that the securitization, *sukuk* and fund management are capable of acquisition, construction or purchase of the asset being leased by the time set for delivery to the lessee. The assets can be sold by the lesser as long as that does not affect the rights of the lessee, in which case the remaining period of rent will be transferred to the new owner.

(ii) As far as *ijarah* contracts are concerned, the terms of lease should be clearly stipulated in detail with all the possible conditions. For example, benchmarking the lease to variables such as inflation rates, periodic price index or otherwise any settled percentage. However, the process of benchmarking has been permitted by mainstream *Shari'ah* experts, even though they do not consider the practice as ideal.

(iii) According to *Shari'ah* rules, the owner is responsible for the condition of the asset at the time of lease, while the lessee bears the responsibility of maintenance and running costs. Consequently, that arrangement will affect the returns from the associated *sukuk*, which cannot be fixed or determined in advance. Therefore, as far as Islamic finance is concerned, *ijarah sukuk* could be taken as quasi-fixed return instrument. The parties involved in the contract could break up the rentals into two parts, one to be paid to the lesser, and the other to be held back by the lessee to cover costs in relation to asset ownership.

(iv) Where *ijarah sukuk* are involved, the Special purpose vehicle (SPV) as purchaser of the asset, issues *sukuk* to the investor, and thus enabling him to pay for his purchase. The asset is then leased to the government or any organisation and in any case the SPV receives periodical rental payments from the lessee and distributes them to *sukuk* holders.

(v) The rentals can be stipulated in the contract in advance and so can rentals on *sukuk* with possibly very insignificant variations due to ownership-related matter, or unpredictable expenses incurred by the lesser or possible any default by the lessee.

2.7.2 *Istisnaa Sukuk*

AAOIFI (2010) defined *istisnaa sukuk* as "certificates of equal value issued with the aim of mobilizing funds to be employed for the production of goods so that the goods produced come to be owned by the certificate holders". It should be noted that where *istisnaa sukuk* are involved, equally valid certificates are issued to generate funds for producing items to be owned collectively by those who buy the certificates, who will then be known as *sukuk* holders. The manufacturer of the items, sometimes known as supplier or seller, issues the certificates. Those who purchase the items are the buyers or subscribers, who then pay the money to fund production costs (Ayub, 2005).

Eventually, the item to be manufactured is to be owned by the holders of *sukuk*, who can get their money back from the sale of *sukuk* or otherwise from the sale of the items. As a matter of fact *istisnaa sukuk* become a good idea in cases where large projects need financing. In case of *istisnaa*, however, it is possible that a parallel i*stisnaa* contract be made with subcontractors, which makes it suitable for financial intermediation (Wilson, 2004). In this regard, a specialised firm could become involved as a subcontractor with a financial institution. According to *Shari'ah*, a debt should not be sold to third party for profit. In other words, *istisnaa* certificates cannot be sold in the secondary market (Shaikh and Saeed, 2010).

2.7.3 *Mudarabah Sukuk*

According to AAOIFI (2010) *mudarabah sukuk* is defined as "certificates that represent projects or activities managed on the basis of *Mudarabah* by appointing one of the partners or another person as the *Mudarib* for the management of operation".

Mudarabah is a type of specialised investment in which the contributor and the beneficiary of the contribution share profits. Although the risk of failure or loss is not ruled out and yet in case of success the contributor becomes eligible to payments in return for his services, while in case of failure or loss he receives nothing (Haider and Azhar, 2011).

According to AAOIFI (2010), the issuer of these certificates is the *mudarib*, the subscribers are the owners of capital and the realized funds are the *mudarabah* capital. The certificate holders own the assets of *mudarabah* and the agreed upon share of the profits belongs to the owners of capital and they bear the loss, if any.

The fact that this structure involves no interest payments on *sukuk* makes it consistent with *Shari'ah* principles. Thus, instead of being fixed periodic payments returns depend on the efficiency of the relevant transactions featuring *mudarabah* (Al-Amine, 2008). In other words, the structure does not violate *Shari'ah* in terms of prohibition of *riba*. The *sukuk* also differ from conventional bonds in that they are not fixed in terms of principal amount (Ayub, 2005). However, in the event of investment featuring *mudarabah*, the purchase price of the shares will be paid to *sukuk* holders as the value of shares may increase or decrease with respect to the principal amount depending on the way *mudarabah* goes (Usmani, 2007). Furthermore, *sukuk* must feature in tangible assets to avoid trading in debts (*bai al-dayn*) (Salah, 2010). In this regard, a tangible asset is traded in the capital market rather than a mere debt. *Sukuk* holders are considered *Rab al-maal* as they are the actual beneficiaries of the shares featuring the tangible assets to be issued by SPV.

2.7.4 *Murabahah Sukuk*

AAOIFI (2010) defines *murabahah sukuk* as "certificates of equal value issued for the purpose of financing the purchase of goods through *murabahah* so that the certificate holders become the owners of the *murabahah* commodity".

The idea of *murabahah sukuk* is to be used as an alternative for loans, where banks make profits from selling *sukuk* to customers (Siddiqi, 2006). In other words, the bank introduces the profit margin with the initial consent of customers (El-Gamal, 2000). However, apart from the agreed upon profit margin, the bank should not charge any other costs as a result of the devaluation of money as a result of inflation. In fact, the idea of *murabahah sukuk* represents the Islamic version of the traditional mortgage in non-Muslim countries, as the main idea is that contrary traditional mortgage contracts, instead of lending money to the client to purchase the asset, the bank purchases the asset, and then sells it to him/her for an agreed profit margin, provided that the clients pays the price by instalment (El-Gamal, 2006). Where *murabahah* is involved, the bank should not incur any charges on the client (Kahf, 2006). However, in return for

potential profit charges to be incurred, the bank could give warrantees to clients for unexpected break down or defective assets (Wilson, 2008).

Therefore, in *murabahah sukuk* contract the bank initially owns the item, which is later transferred to be registered in the name of the buyer who will benefit from it by receiving tax credit (El-Gamal, 2000). However, from *Shari'ah* point of view, *murabahah* sales are to be excluded from interest-based transactions for the following reasons (Kahf and Khan, 1992; Al-Amine, 2001; El-Gamal, 2007):

(i) The bank bear responsibility of any risks involved as an initial owner of the asset or property;

(ii) The bank plays the role of a trading agent rather than financier;

(iii) The transaction involves an asset or commodity rather than cash loans.

It is worth mentioning that *murabahah* contracts represent the dominant transactions with increasing popularity in the Islamic world (Iqbal, 1997). In terms of advantages with respect to the banking business, *murabahah* transactions have shorter risk duration as compared to other financing techniques. In case of *murabahah* contracts, the profit margin is determined at the completion of the sale, and according to *Shari'ah* principles the asset or property involved cannot be resold as they represent receivable (debts), and that the liquidity of investment remains an impending concern for Islamic banks (AAOIFI, 2010).

It should be noted that *murabahah sukuk* only become legally valid in primary markets. In terms of *Shari'ah* principles, the validity the *sukuk* in secondary markets is questionable (AAOIFI, 2010). This is for the simple reason that the certificates feature money owed by the subsequent buyer of the asset to holders of the certificate, and that makes such practice similar to trading in debts on deferred basis which amounts to *riba* (Shaikh and Saeed, 2010).

Despite their debt-based structure *murabahah sukuk* could be acceptable provided they constitute a small part of a package featuring other structures such as *mudarabah*, *musharakah* and *ijarah*. Nonetheless, in countries such as Malaysia where liberal interpretation of *Shari'ah* dominates, *murabahah sukuk* have become

more popular, as in such countries a debt sale (*bai al-dayn*) at negotiated prices is allowed by jurists (Thomas, 2007).

2.7.5 *Musharakah Sukuk*

According to AAOIFI (2010) *musharakah sukuk* is defined as "certificates of equal value issued with the aim of using the mobilized funds for establishing a new project, developing an existing project or financing a business activity on the basis of any partnership contracts so that the certificate holders become the owners of the project or the assets of the activity as per their respective shares, with the *musharakah* certificates being managed on the basis of participation or *mudarabah* or an investment agency".

It should be noted that *musharakah sukuk* is currently used by financial corporations to develop projects as well as other business activities (Tariq, 2004). Thus, in *musharakah*-based activities, SPV funds corporations through issuing *musharakah sukuk* for this purpose. Corporations could make in kind contributions to the capital in form of land to be used to establish projects on behalf of SPV. In the process, the corporation purchases shares from SPV for an agreed price and time duration. Proceeds then generated from the business activity are to be distributed among *sukuk* holders in accordance with *musharakah* agreement (Ayub, 2005).

2.7.6 *Salam Sukuk*

AAOIFI (2010) defines the working mechanism of *salam sukuk* as "The issuer of the certificates is a seller of the goods of *salam* and the subscribers are the buyers of the goods, while the funds realized from subscription are the purchase price (*salam* capital) of the goods. The holders of *salam* certificates are the owners of the *salam* goods and are entitled to the sale price of the certificates or the sale price of the *salam* goods sold through a parallel *salam*, if any".

It should be mentioned that *salam sukuk* normally issued for generating a capital, therefore, the goods or assets to be delivered in return for that capital will come to the ownership of *sukuk* holders who subscribe to the capital as the certificates will be sold by the issuer to the buyers who will then be known as subscribers (Ayub, 2005). In other words, subscribers provide *salam* capital to assist the purchase of goods or assets, and therefore the *sukuk* holders become the real owners of the goods or assets,

and they can redeem their money from the sales of goods or otherwise the sale of certificates provided the goods have already been delivered. In this regard SPV may join the arrangement of *salam sukuk*. The SPV can sell *salam sukuk* to investors and the money to be generated could be paid to companies by SPV to deliver commodities in future. Marketing of commodities can either take place directly by SPV or indirectly by through an agent to generate profits favouring SPV and *sukuk* holders (El-Gamal, 2005; Ahmad, 2009).

It should be noted that *salam sukuk* can be described as the Islamic version for the traditional forward or future contracts (Haider and Azhar, 2011).

2.7.7 *Wakalah Sukuk* (Agency *Sukuk*)

Wakalah sukuk are considered innovative structures and the most recent structure in comparison with other *sukuk* structures (El Shazly and Tripathy, 2013). *'Wakalah'* is an Arabic word, which is translated as an 'agency'. The concept of the agency structure is that it comprises two parties where the first party entrust the second party to act in his behalf as an agent. In the agency *sukuk* structure, the *sukuk* holders appoints an investment manager as *wakel* to manage and invest the underlying *sukuk* assets whether the assets represent tangible assets or usufructs and services. The *wakalah* agreement in most cases is constituted for a period limited and it is irrevocable. Moreover, the *wakel* normally receive a payment in return for his management as well as he can be eligible to obtain a percentage of the profit for his good management at the end of the agency agreement as incentive (Latham and Watkins, 2015).

The structure of the *wakalah sukuk* is considered useful when the *sukuk* holders have tangible assets as the *wakel* manages directly these assets in exchange for a payment and an incentive. In fact, there is to some extent similarity between the structure of the *wakalah sukuk* and *mudarabah sukuk*. The main difference between the two structures is that the whole profits in the *mudarabah* structure will be divided between the *sukuk* holders and the *mudarib* according to the percentage agreed upon in the contract of the *mudarabah*. However, in the case of the *wakalah sukuk*, the *sukuk* holders will receive only the percentage of profit specified in the prospectus of issuance and whatever profit exceeds that percentage will be retained at a reserve account in

expectation of any risks. However, any amount that is kept at the reserve account will be given at the end of the agency agreement to the *wakel* for his good management (DIFC, 2009).

2.7.8 *Istithmar Sukuk* (Investment *Sukuk*)

Istithmar sukuk is sometimes referred to as *al-wakalah bel-Istithmar sukuk* (investment agency *sukuk).* In most cases, the underlying *sukuk* assets whether tangible or intangible should be considered when the appropriate *sukuk* structure is selected (Latham and Watkins, 2015). In this regard, the tangible assets can be structured easily as there is no disagreement among *Shari'ah* scholars in this regard. However, if the underlying *sukuk* asset is intangible then the controversy can emerge. The disagreement between the *Shari'ah* scholars is according to the real possibility to transfer and evaluate these intangible assets legally as well as financially; and whether such transferring and evaluation are acceptable from the *Shari'ah* point of view, this issue will be discussed in details in Chapter 6.

One of the most widespread structures of investment *sukuk* is the 'rights *sukuk* structure as it has been indicated above. These rights will be represented as future financial dues (receivables), which can be structured, based on deferent Islamic contracts. These rights are gathered and formed as an asset and can be sold and owned. However, caution should be taken when drafting and forming contracts of such intangible assets so that it should not be similar to trading in debt which is considered *riba* based transaction (DIFC, 2009; Latham and Watkins, 2015).

The Arabic term *'istithmar'* is literally means 'investment' as the most widespread Islamic contract under the investment structure is *ijarah* as the *murabahah* and *istisnaa* receivables can also be used. The share of each *sukuk* holder and the certificates of *sukuk* can also be gathered as a package and sold as an investment based on intangible assets. The future profits as result of the investment structure will be distributed according to the *sukuk* structure issuance (DIFC, 2009; Latham and Watkins, 2015).

The term '*istithmar'* is recently used when many financial institutions turned to the adoption of intangible underlying assets instead of tangible assets such as the right to receive future proceeds. Accordingly such structure often indicates that the structure is designed based on intangible assets. In contrast, the *wakalah sukuk* structure is also considered as new inventions in the Islamic financial industry; however, this structure often designed on tangible asset (DIFC, 2009; Latham and Watkins, 2015).

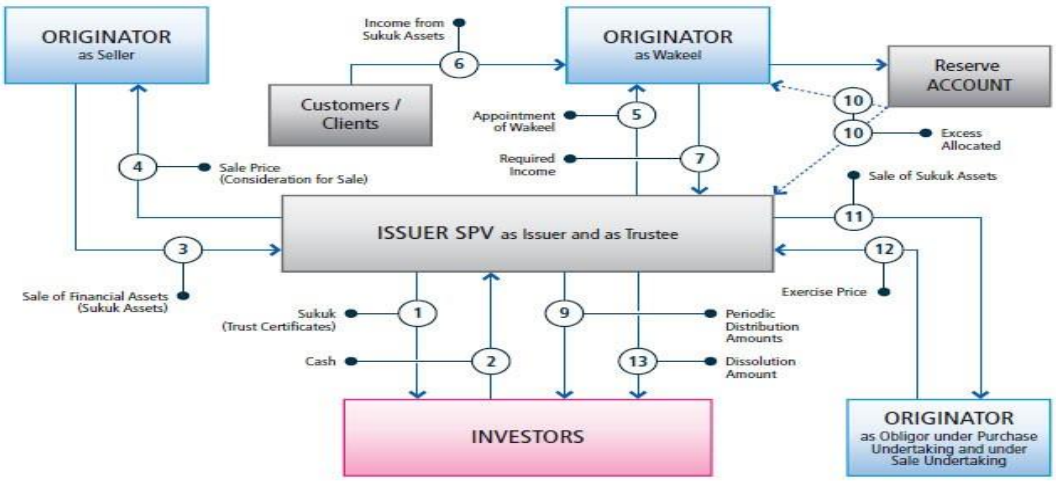
Due to the emergence of innovative structures such as *wakalah* structure, which is based on underlying intangible assets or on a mixture of tangible and intangible assets, the *wakalah bi istithmar* structure appeared as a new concept among financial institutions especially the IDB. In this regard, the *sukuk* holders appoint the issuer as *wakeel bil istithmar* based on the nature of *Shari'ah* contract. The issuer of *sukuk* is the *wakeel bil istithmar* and the subscribers are the clients; the IPO proceeds in the principal is the amount to be invested and the *sukuk* holders, which will be the owner for what *sukuk* represent in the form of gains and loose and they have the right for profit, if any.

Therefore, it could be said that the term '*sukuk al istithmar'* is considered as a general term which other types of *Shari'ah* contracts fall below the term '*sukuk al istithmar'* such as *ijarah, mudarabah, musharakah etc*., considering that the underlying assets under the term *sukuk al istithmar* are tangible assets. However, the *wakalah bil istithmar sukuk* structure is considered as a new innovation designed when the underlying asset of *sukuk* is intangible or a mixture (DIFC, 2009; Latham and Watkins, 2015).

That is probably what made the ZAWYA database to differentiate between the term *sukuk al istithmar* and *the sukuk al wakalah bil istithmar*. In this regard, it should be noted that the *wakalah* and the *wakalah bil istithmar* contracts are investment contracts between the *sukuk* holders and the *wakeel*, which is in most cases the issuer, and then the *Shari'ah* contracts come later between the *wakeel* and a third party.

It should be mentioned that the *istithmar sukuk* structures have recently become popular, which also used in the structuring of SABIC *sukuk* which constitutes the case study in this research. Therefore, the structure of *istithmar sukuk* is depicted in Figure 2.1, and its working mechanism is explained in detail.

Figure 2.1: The Steps for the Structure of *Istithmar Sukuk*



Source: DIFC (2009:52)

According to the DIFC (2009:52), the steps for the structure of *istithmar sukuk* can be summarised as follows:

(i) "Issuer SPV issues *sukuk*, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

(ii) The Investors subscribe for *sukuk* and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

(iii) Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, a portfolio of certain financial assets (the "*Sukuk* Assets") from Originator.

(iv) Trustee pays the purchase price to Originator as consideration for its purchase of the *Sukuk* Assets in an amount equal to the Principal Amount.

(v) Trustee appoints Originator as its *wakeel* (or agent) with respect to the *Sukuk* Assets for a term that reflects the maturity of the *sukuk*. Originator is responsible for servicing the *Sukuk* assets and, in particular, collection of the income (comprising principal and profit) therefrom.

(vi) Originator collects income in respect of the *Sukuk* assets from the relevant customers/clients and will deposit these amounts into a collection account (the "Collection Account").

(vii) At regular intervals, corresponding to Periodic Distribution Dates, Originator will be required to make income payments to Trustee in respect of the *Sukuk* assets. This will be achieved through a target amount (the "Required Income"), which is agreed for each collection period. The amount of Required Income during a collection period will be equal to the Periodic Distribution Amount payable under the *sukuk* at that time. This amount may be calculated by reference to a fixed rate or variable rate (*e.g*. London Interbank Offered Rate (LIBOR) or Singapore Interbank Offered Rate (SIBOR) depending on the denomination of *sukuk* issued and subject to mutual agreement of the parties in advance.

(viii) During a particular collection period, if the income amount collected in respect of the *Sukuk* assets (as reflected in the Collection Account) is in excess of the Required Income such excess can either be: credited to a reserve account (the "Reserve Account") with Originator; or in a case where a financial asset has matured (and principal therefrom has been repaid by the customer/client), and in order to avoid excess cash in the structure, used to purchase additional financial assets under the purchase arrangement referred to in paragraph 3 above (and which will then become *Sukuk* assets).

(ix) The balance in the Reserve Account (if any) can also be used to cover a shortfall in collections to meet the Required Income in any given collection period. In the event that there is a shortfall in both collections and the Reserve Account, it may be permissible for Originator to make an on-account payment or to provide *Shari'ah*-compliant liquidity funding to bridge any gap in funding.

(x) Issuer SPV pays each Periodic Distribution Amount to the Investors using the Required Income it has received from Originator.

(xi) Upon redemption of the *sukuk* (see paragraph 11 below), the balance of the Reserve Account (if any) will be paid (being the "Distributed Reserve Amount") to Trustee in order to enable the payment of the Dissolution Amount to the Investors. The excess (if any) will be retained by Originator as incentive fees.

(xii) Upon an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or the exercise of an optional call (if applicable to the *sukuk*) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking), Trustee will sell, and Originator will purchase, the *Sukuk* assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors less the Distributed Reserve Amount (if any) Payment of Exercise Price by Originator (as Obligor).

(xiii) Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price and the Distributed Reserve Amount (if any) it has received from Originator'.

(xiv) 'Issuer SPV issues *sukuk*, which represent an undivided ownership interest in an underlying asset or transaction. They also represent a right against Issuer SPV to payment of the Periodic Distribution Amount and the Dissolution Amount.

(xv) The Investors subscribe for *sukuk* and pay the proceeds to Issuer SPV (the "Principal Amount"). Issuer SPV declares a trust over the proceeds (and any assets acquired using the proceeds – see paragraph 3 below) and thereby acts as Trustee on behalf of the Investors.

(xvi) Originator enters into a sale and purchase arrangement with Trustee, pursuant to which Originator agrees to sell, and Trustee agrees to purchase, a portfolio of certain financial assets (the "Sukuk Assets") from Originator.

(xvii) Trustee pays the purchase price to Originator as consideration for its purchase of the Sukuk Assets in an amount equal to the Principal Amount.

(xviii) Trustee appoints Originator as its *wakeel* (or agent) with respect to the *Sukuk* assets for a term that reflects the maturity of the *sukuk*. Originator is responsible for servicing the *Sukuk* assets and, in particular, collection of the income (comprising principal and profit) therefrom.

(xix) Originator collects income in respect of the *Sukuk* assets from the relevant customers/clients and will deposit these amounts into a collection account (the "Collection Account").

(xx) At regular intervals, corresponding to Periodic Distribution Dates, Originator will be required to make income payments to Trustee in respect of the *Sukuk* assets. This will be achieved through a target amount (the "Required Income"), which is agreed for each collection period. The amount of Required Income during a collection period will be equal to the Periodic Distribution Amount payable under the *sukuk* at that time. This amount may be calculated by reference to a fixed rate or variable rate (*e.g.* LIBOR or SIBOR) depending on the denomination of *sukuk* issued and subject to mutual agreement of the parties in advance.

(xxi) During a particular collection period, if the income amount collected in respect of the *Sukuk* assets (as reflected in the Collection Account) is in excess of the Required Income such excess can either be:

(a) credited to a reserve account (the "Reserve Account") with Originator; or

(b) in a case where a financial asset has matured (and principal therefrom has been repaid by the customer/client), and in order to avoid excess cash in the structure, used to purchase additional financial assets under the purchase arrangement referred to in paragraph 3 above (and which will then become Sukuk Assets).

The balance in the Reserve Account (if any) can also be used to cover a shortfall in collections to meet the Required Income in any given collection period. In the event that there is a shortfall in both collections and the Reserve Account, it may be permissible for Originator to make an on-

account payment or to provide *Shari'ah*-compliant liquidity funding to bridge any gap in funding.

(xxii) Issuer SPV pays each Periodic Distribution Amount to the Investors using the Required Income it has received from Originator.

(xxiii) Upon redemption of the *sukuk* (see paragraph 11 below), the balance of the Reserve Account (if any) will be paid (being the "Distributed Reserve Amount") to Trustee in order to enable the payment of the Dissolution Amount to the Investors. The excess (if any) will be retained by Originator as incentive fees.

(xxiv) Upon an event of default or at maturity (at the option of Trustee under the Purchase Undertaking); or the exercise of an optional call (if applicable to the sukuk) or the occurrence of a tax event (both at the option of Originator under the Sale Undertaking), Trustee will sell, and Originator will purchase, the *Sukuk* Assets at the applicable Exercise Price, which will be equal to the Principal Amount plus any accrued but unpaid Periodic Distribution Amounts owing to the Investors less the Distributed Reserve Amount (if any) Payment of Exercise Price by Originator (as Obligor). Issuer SPV pays the Dissolution Amount to the Investors using the Exercise Price and the Distributed Reserve Amount (if any) it has received from Originator''.

2.8 BASIC STRUCTURE OF PREVAILING *SUKUK* DOMINATING MARKETS

According to AAOIFI (2010) there are various kinds of *sukuk* depending on the type of Islamic models of financing and trade utilized in the structure. The most common types include *ijarah, musharakah*, *mudarabah*, *murabahah*, *salam* and *istisnaa.* In this regard, *sukuk* investment can be classified into three types: *sukuk* for trading purposes, *sukuk* for sale, and *sukuk* held up to maturity (Abdulrahman and Abdul Rahim, 2003). However, *Shari'ah* law featuring trade commodities for the purpose of *sukuk* constitutes the basis for the above classification (Ahmed, 2011).

It should be mentioned that in any arrangement involving *sukuk* three parties are involved: the manager of *sukuk* (originator), the special purpose vehicle (issuer of

sukuk certificates SPV), and the investors who buy the certificates (Tariq and Dar, 2007). According to (Adam and Thomas, 2004; Usmani, 2007; Al-Amine, 2008; DIFC, 2009), the basic structure of existing *sukuk* could be understood in the following points;

(i) The Originator of the *sukuk* sells assets to be leased to the SPV who is the issuer of the *sukuk;*
(ii) The payment for assets sold will be received by the Originator;
(iii) The Originator leases back assets from SPV;
(iv) Rent payments will be received by SPV from the originator under the terms of a special contract;
(v) In order to finance the purchase of assets from the originator, the SPV collects funds from issuances of *sukuk* certificates;
(vi) Rent payments from the originator are utilized by SPV for dispersing distributions on *sukuk* certificates;
(vii) Conventional investors as well as Islamic investors tend to secure *sukuk* certificates;
(viii) Distributions from SPV tend to provide periodical reimbursements for investors.

In the meantime, rental payments given out by the originator featuring leased assets provide funds for SPV. Finally, at the end of the term of *sukuk*; the collective *sukuk* holders would become owners of the assets, and eventually owners of the lease of the assets. At this point the holders would find out as to whether they have gained or lost on their assets depending on the market price at the time. Consequently, in case the assets in question have no viable market, then the originator has to incur higher costs. However, it is most likely that the originator may be unwilling to give up the assets when the contract expires. For this reason, it is recommended that any *sukuk* contract should feature a provision indicating the originator's willingness to re-purchase the assets at their face value. The SPV on the other hand, can be described as lonely and separate entity from the originator. However, the fact that the originator has to channel payments through a clearing house could provide a consolation for the SPV, and also for certificate holders who will then be paid by the same arrangement as well (Tariq and Dar, 2007).

2.9 GLOBAL DEVELOPMENTS AND TRENDS IN ISLAMIC CAPITAL MARKET (*SUKUK*) INVESTMENTS

Since the early 1990s, the IBF has been popular in Muslim countries and beyond in the international stage. That has become obvious from the number of Islamic banks that have been established across the Muslim world: the Banker (2015) put the number of IBF institutions worldwide at 500 institutions. In the institutional development trajectory, initial institutionalization was very much Islamic retail banking, while the second institutional development was marked with commercial and investment banks and Islamic fund management. It should be noted that there has been important improvements in the developments in the Islamic financial markets as from 2007 to 2014, the total assets in Islamic banking have increased by 15.73% at compound annual growth rate (The Banker, 2014).

In the third development stage, Islamic finance has witnessed the emergence of Islamic financial, capital, and money markets since the beginning of this century. In particular, global developments and appetite for *sukuk* should be taken into account as the emerging thrust of Islamic financial development.

Given the current instability and changeability in the financial markets worldwide, which definitely tend to increase the risks associated with the traditional bond markets. This could provide a real chance for the Islamic financial system to dominate the markets as a rescuer. In this regard, Islamic bonds or *sukuk* should be able to do fulfill such an expectation without the need for speculation or exploitation of resources a characteristic associated with the traditional financing system (Sheikh and Saeed, 2010).

The first *sukuk* issued in 1990 in Malaysia, which rapidly flooded the financial markets by playing a major role in capital investment as since their emergence into the financial markets *sukuk* have made major contributions to the process of economic development in many Muslim countries (Akram, 2008). The success of Islamic capital markets or *sukuk* has been motivated by a number of factors, such as: economic need, providing Muslim investors with reliable means as an alternative to religiously un-sounding financial practices, and most importantly the need for activating Islamic capital markets. Thus, the idea of *sukuk* has emerged to raise the profile and volume of Islamic capital markets in the global arena (Yean, 2009). This is

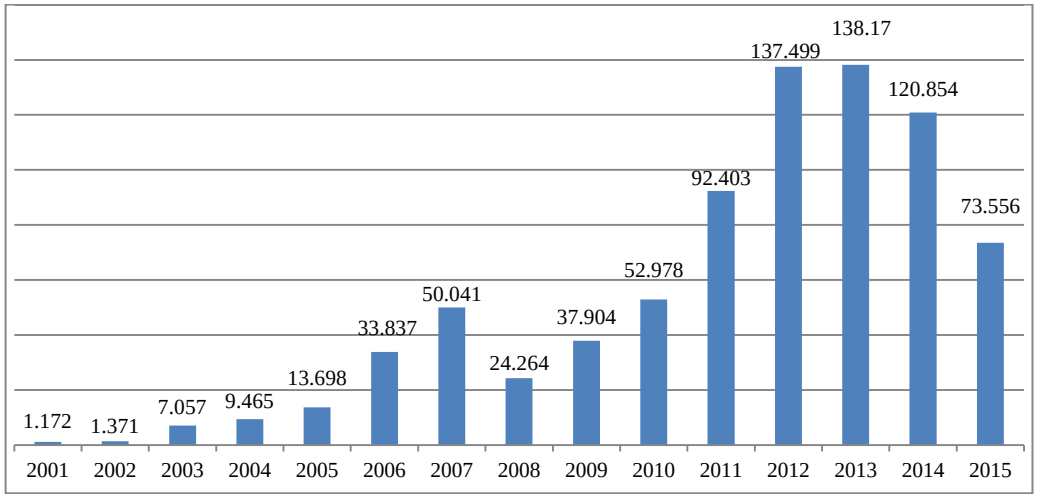
further confirmed by Iqbal Mirakhor and (2011), who deem the idea of *sukuk* as the most popular product in relation to the Islamic system of finance.

In response to the increasing demand for Islamic financial services particularly in the GCC countries, a conference was held in Saudi Arabia in 1988. The conference was supervised by the Islamic *Fiqh* Academy to discuss the means of developing capital markets (Nathan and Pierce, 2010). Eventually, the conference approved *sukuk* as a financial practice consistent with the principles of *Shari'ah*. That approval has given the chance for Islamic investors to practice their financial activities without offending *Shari'ah* law contrary to conventional financial practices such as debt securities, which are offensive to *Shari'ah* (Wilson 2004).

Consequently, *sukuk* were issued for the first time in Malaysia, in the form of Shell NDS, for a total value of USD 30 million by a non-Muslim institution (IIFM, 2010). In another development in the year 2000, the Sudanese government issued *musharakah sukuk* for a total value of SP 77 million. It should be stated that *salam sukuk* were the first to reach international markets issued by the Kingdom of Bahrain in September 2001. That was followed by first dollar-dominated international sovereign *ijarah sukuk* for a total value of USD 100 million by Malaysia. Again in Malaysia, an organisation referred to as Kumpulan Guthrie issued a five-year quasi-sovereign *ijarah sukuk* for a total value of USD 150 million (IIFM, 2010).

After the initial success with *sukuk*, many Muslim countries started to issue *sukuk* whether sovereign or corporate and whether at domestic or international level. As a result of this expansion, the *sukuk* markets have become one of the robust foundations of the Islamic financial industry. In addition, as a result of financial engineering and innovation, different structures of the *sukuk* issued recently such as *ijarah*, *musharakah* and *mudarabah* (Yean, 2009; Shaikh, 2012).

Figure 2.2: Global *Sukuk* Issuances, 2001-2015 ($M)

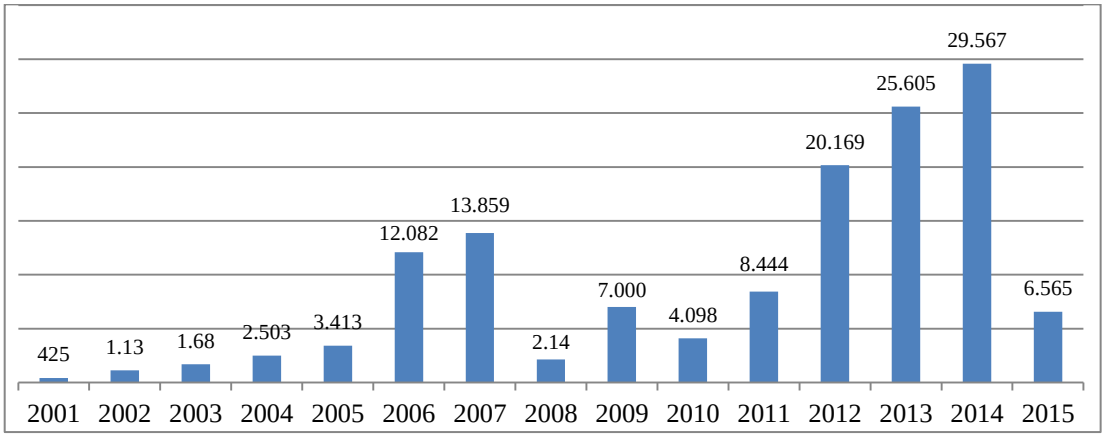


Data Source: IIFM *Sukuk* Database (2014); Zawya *Sukuk* Database (2015)

Figure 2.2 depicts the trends in the global *sukuk* issuances for the period of 2001-2015; as can be seen from a very humble beginning and despite the impact of global financial crisis from 2007 to 2009, *sukuk* market has successfully picked up and reached its peak in 2013 with USD 138 billion.

Figure 2.3, on the other hand, displays the international *sukuk* issuances, in the sense that companies in a certain country or government of a certain country issues *sukuk* in different jurisdiction. Trends observed in Figure 2.3 are also seen in international *sukuk* issuances. As can be seen from a limited international issuance, and despite the adverse impact of the global financial crisis, it peaked to approximately USD 30 billion in 2014.

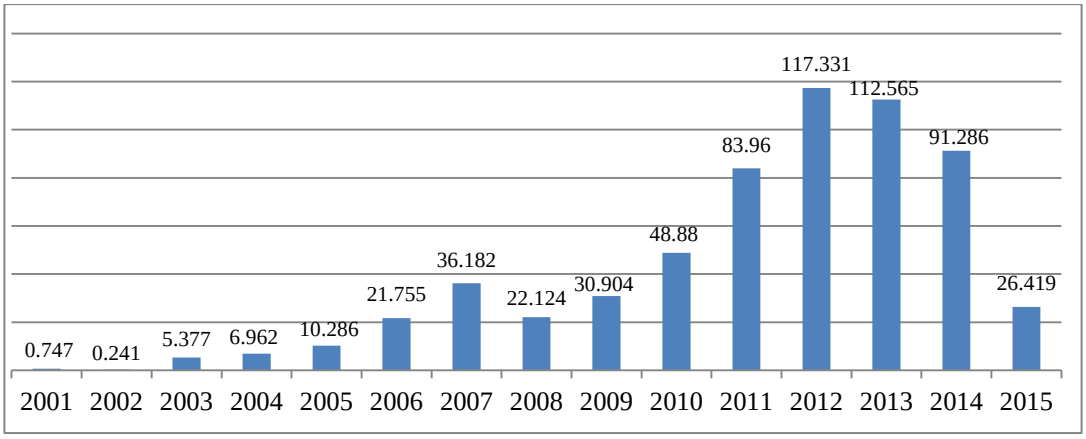
Figure 2.3: Global *Sukuk* Issuances, International Jurisdictions, 2001- 2015 ($M)



Data Source: IIFM *Sukuk* Database (2014); Zawya *Sukuk* Database (2015)

The trends in domestic *sukuk* issuances can be seen in Figure 2.4, which demonstrates a very similar trend by reaching its peak in 2012 at USD 117 billion after overcoming the adverse impact of the global financial crisis.

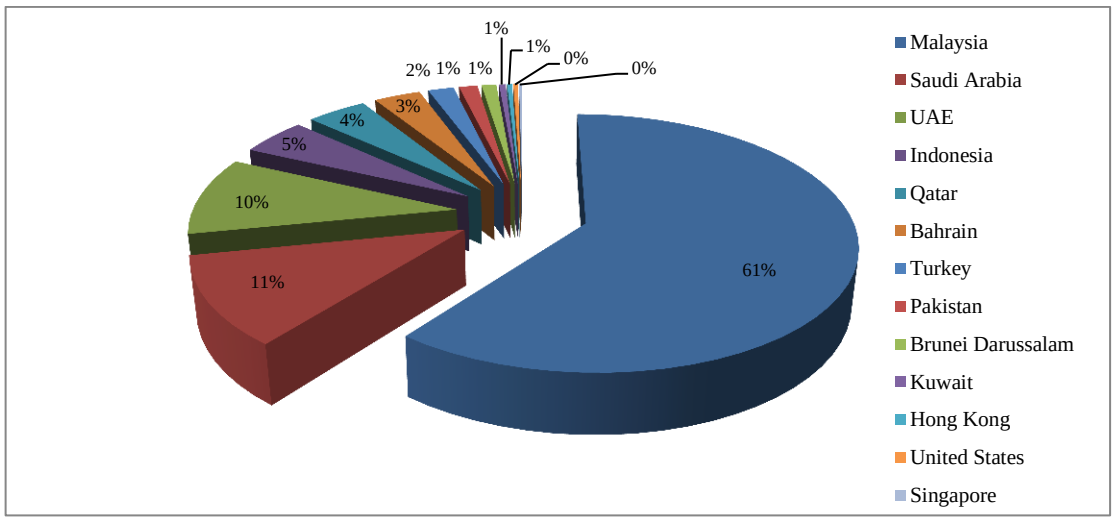
Figure 2.4: Domestic *Sukuk* Issuances, 2001-2015 ($M)



Data Source: IIFM *Sukuk* Database (2014); Zawya *Sukuk* Database (2015)

In overall, since 2001, particularly after the global financial crisis in 2007, domestic as well as international *sukuk* markets have substantially flourished. As can be seen, 2014 is considered distinctive, especially in relation to the issuances of international *sukuk*, as the value of issued *sukuk* reached nearly USD 30 billion compared with the year 2013, when it reached approximately USD 26 billion. Once again, the increase in the issued *sukuk* in the years 2013-2014 as compared with the issuances took place before the financial crisis in 2007 is considered a considerable benchmark and a good benchmark of the prosperous future that will be witnessed by *sukuk* market.

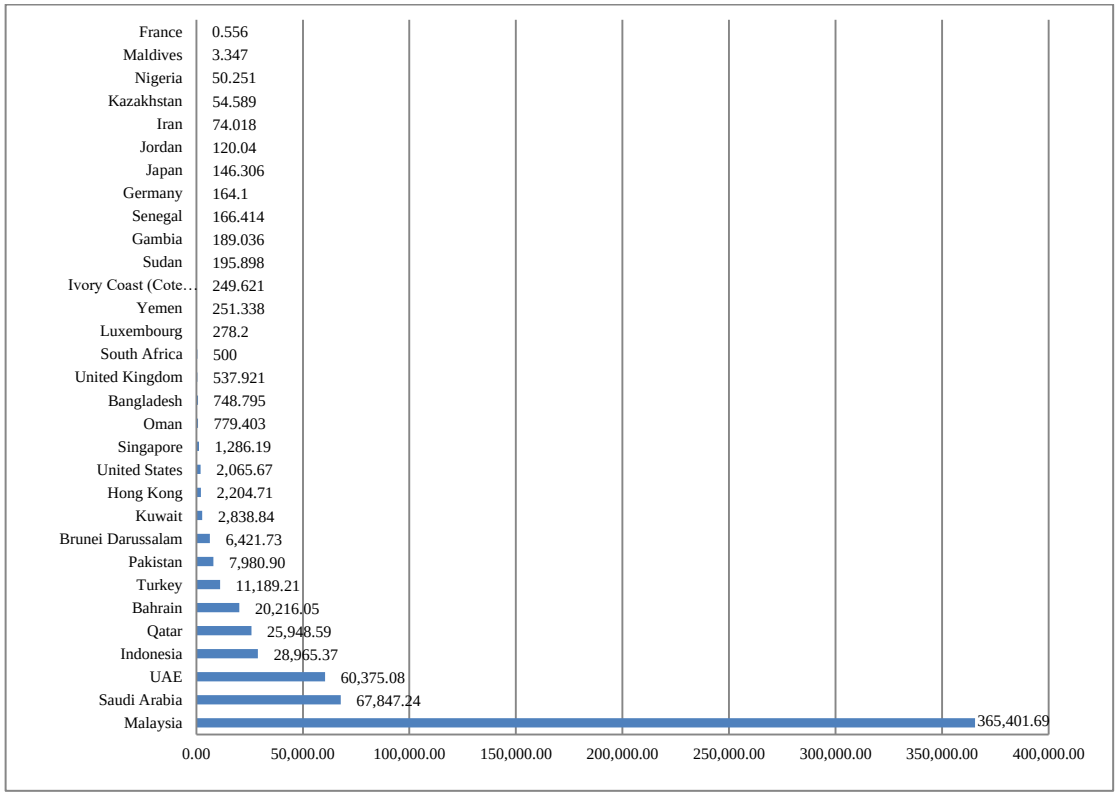
Figure 2.5: Total Size of The Large *Sukuk* Issuers, 2001-2015 ($M)



Data Source: Zawya Database (2015)

Figure 2.5 depicts the breakdown of *sukuk* issuances according to countries. The remarkable increase in the demand for *sukuk* issuances, especially in Asia such as Malaysia and Indonesia as well as the GCC such as Saudi Arabia, UAE, Qatar and Bahrain is considered as the major drive that led to the booming and continued development of the *sukuk* market at international level. Additionally, the entering of new issuers, the increase in the liquidity level at different Islamic financial Islamic institutions as well as the increase of issuances in various currencies and issuance of short term *sukuk*, all these factors led the international *sukuk* market to achieve this remarkable development. As result of the expansion and progress, the value of *sukuk* issuances has escalated from USD 1.7 million in 2001 to approximately USD 121 billion in 2014, as it can be seen in Figure 2.2.

Figure 2.6: Total Size of Issues, 2001-2015 ($M)



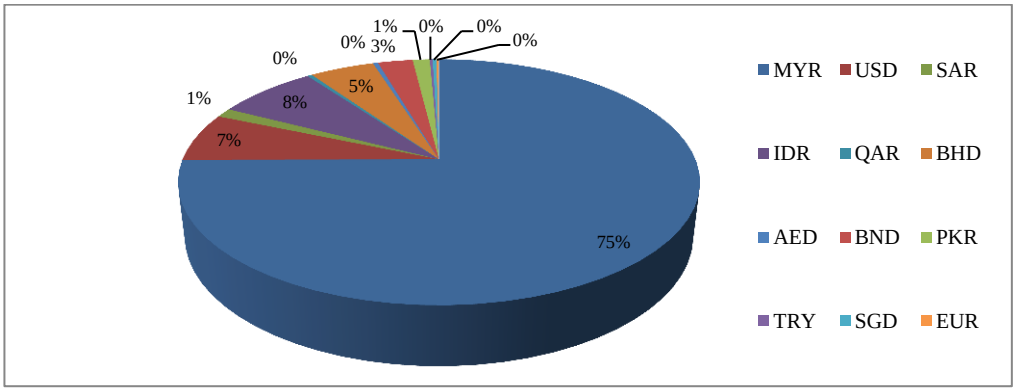
Data Source: Zawya Database (2015)

Another positive trend that can be witnessed for the progress of the *sukuk* market, as can be seen in Figure 2.6, is that the idea of the *sukuk* has widely spread in non-Muslim countries. These countries include UK, Hong Kong, South Africa and others which joined the market in 2014. This trend has a significant impact on supporting and enhancing the idea of investing in the Islamic financing instrument especially

sukuk. Likewise, investment in *sukuk* market made the *sukuk* as a financing instrument and a competitive tool with conventional interest-based bonds.

Another positive trend which the *sukuk* markets have witnessed recently is the wide spread issuances of foreign currencies based *sukuk* in as it can be seen in Figure 2.7. As can be seen in Figure 2.7, *sukuk* markets witnessed escalation in the issuance of *sukuk* in foreign currencies, especially in USD whereas Malaysia has attracted foreign issuances from Turkey and Singapore according to Global *Sukuk* Report GSR (2015).

Figure 2.7: Global *Sukuk* Issuances Currency Break-Up, Jan 2001-2015 ($M)



Data Source: Zawya Database (2015)

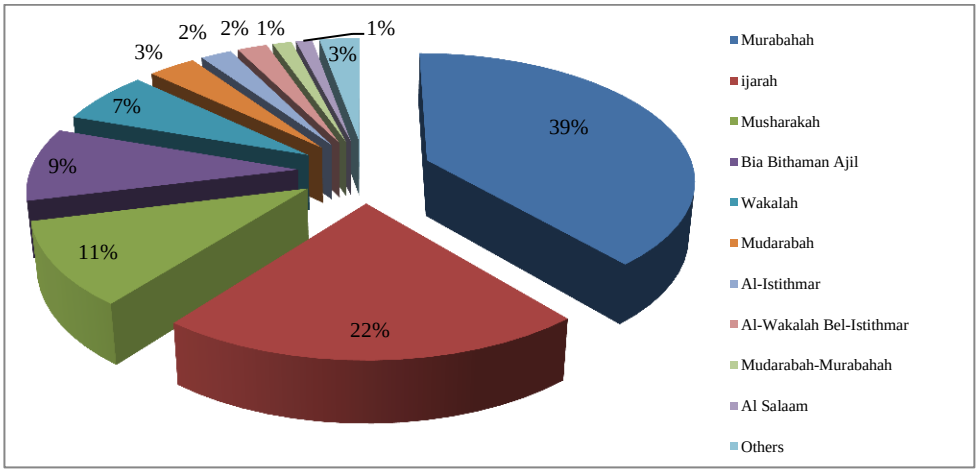
As can be seen in Figures 2.5 and 2.6, in the period between 2001-2015, Malaysian market topped the list of the countries issuing *sukuk*, with an estimated total value of USD 365 billion at domestic and international markets. The Saudi Arabian market ranked second with the volume of issuance with approximately USD 68 billion, followed by the UAE with USD 60.75 billion. In addition, Malaysian *sukuk* market still occupies the leadership in the Islamic finance industry because its market is characterised by stability, well-establishment and confidence of investors. However, this leadership can be affected in future due to the large issuances of *sukuk* by countries that have significant economic value, such as KSA, UAE, Qatar, Bahrain, Indonesia and Turkey.

As regards to domestic *sukuk* markets, Malaysia is again considered on the top of the list of the largest countries in issuing *sukuk*. The volume of the domestic Malaysian *sukuk* market is estimated to constitute 78% of the percentage of the total volume of the other *sukuk* markets despite the presence of large markets such as those in Indonesia, Qatar, KSA or Saudi Arabia and Turkey. It worth to mention that there are

domestic markets, which are active in issuing *sukuk*, especially in Indonesia, Turkey and Pakistan as it has been mentioned above. Such progress has come as the result of facilities and support given to Islamic banks and institutions by both central banks as well as investors who were interested in investing the liquidity they possess in the *sukuk* issued by the government. This positive trend by these central banks has been augmented by the opening of new markets such as Senegal *sukuk* market and the Gambia *sukuk* market, which have opened recently. This is itself considered also a positive direction which is due to the wide spread and acceptance of *sukuk*. The announcement for many *sukuk* issuances at foreign currency markets such as London, Irish and Luxembourg Stock Exchange is in fact considered another positive direction which the *sukuk* markets have witnessed internationally (IIFM,2014; Zawya, 2015).

In terms of the popular structures used (number and size) in the period between 2001-2015 whether at the domestic or international markets is *murabahah sukuk* structure as the estimated value was approximately USD 252,139 million with 39% of the total issuances as it can be shown in Table 2.1 and Figure 2.8. This followed by structures of *ijarah sukuk* with the volume of approximately USD 141,110 million with 22% of total *sukuk* issuances and *musharakah sukuk* with 11% of the total issuances.

Figure 2.8: *Sukuk* Issuances Breakdown by Type and Size, 2003-2015 ($M)



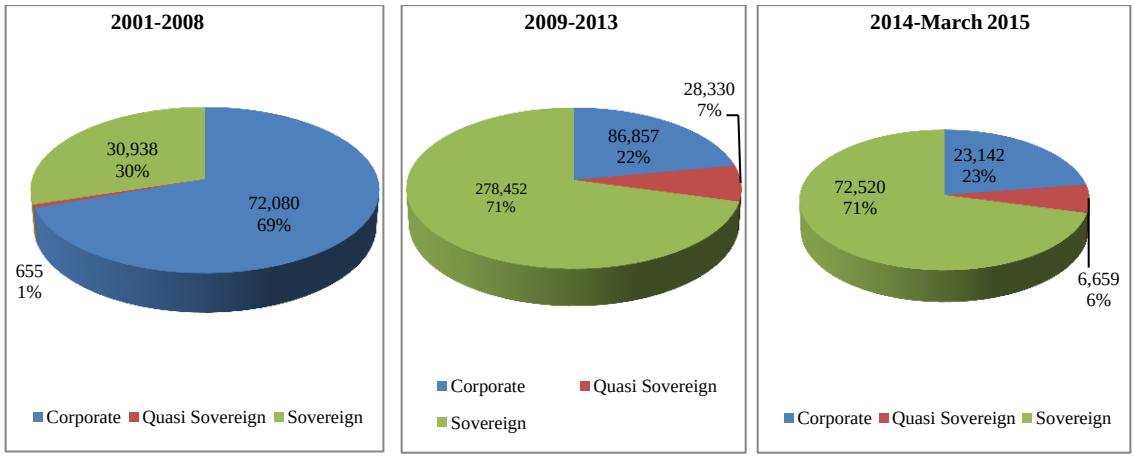
Data Source: Zawya Database (2015)

In general, the diversified issuances of *sukuk* and their international spread in addition to the remarkable development in *sukuk* structures have impact on assisting *sukuk* to reach high records in a relatively short span of time especially after the global financial crisis as it has been indicated above.

Figure 2.9 and Figure 2.10 depicts domestic *sukuk* issuances by issuer status for the January 2001- March 2015 (in USD Millions) and international *sukuk* issuances by issuer status for the January 2001- March 2015 (in USD Millions), respectively. At domestic market, the volume of issuance of sovereign and quasi-sovereign *sukuk* in the period from January 2014 to March 2015 reached approximately 71% and 23% respectively of the total issuances. This percentage is close to some extent to the period between 2009-2013, when the volume issuance of *sukuk* of this particular type of *sukuk* reached 71% and 22% respectively (IIFM, 2014). This indicates conspicuously that there is a significant activity in the issuance of sovereign and quasi-sovereign *sukuk*, while the percentage of issuance of corporation *sukuk* is considered les when compared with this kind of *sukuk* as it can be seen in Figure 2.9.

However, the period between 2001-2008, the share of issuance of corporation *sukuk* in the domestic market comparing to others was historic with 69% of *sukuk* issuance as it can be seen in Figure 2.9.

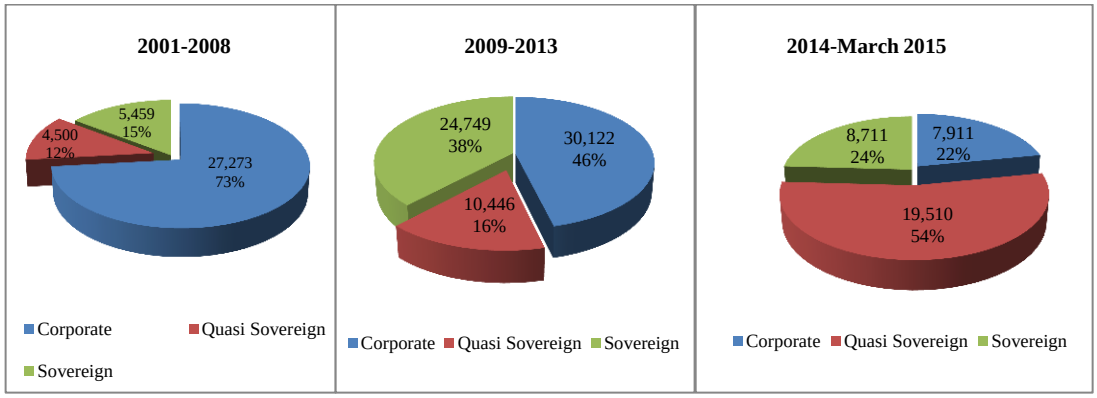
Figure 2.9: Domestic *Sukuk* Issuances by Issuer Status,2001-March 2015, ($M)



Data Source: IIFM *Sukuk* Database (2015)

As depicted in Figure 2.10, the volume of the issuance of sovereign and quasi-sovereign *sukuk* in the International markets has witnessed significant increase. For instance, in the period between 2009- 2013, it constituted approximately 54% of the total issued *sukuk*, while in the period from January 2014 to March 2015 there was a notable increase and the percentage reached 78% (IIFM, 2014). This means that the percentage of corporate *sukuk* at the global markets is still below the desired target, as depicted in figures 2.9 and 2.10.

Figure 2.10: International *Sukuk* Issuances by Issuer Status, 2001-Mar 2015 ($M)



Data Source: IIFM *Sukuk* Database (2015)

As consequences of the repeat issuances of *sukuk* by non-Muslim countries, the *sukuk* markets can be developed in the future in regard to the progress and spread of *sukuk* issuances. In addition, the rules and laws that will regulate issuances and circulation of *sukuk* will be considered as result of the new non-Muslim countries entering to the *sukuk* market recently. Additionally, these non-Muslim countries will have their impact on considering of *sukuk* structures, particularly in terms of risks and methods for its mitigation, as *sukuk* related risks have not been given due attention in many deferent Muslim countries in terms of examination and scrutiny.

Among the reasons also that led to the increase of volume of the sovereign *sukuk* issued recently is the tendency adopted by certain governments in certain countries for taking advantage of the increase in demand for *Shari'ah* compliant financial assets as well as the increase of the support for the objectives of their internal policies for Islamic finance. In this regard, it should be noted that *sukuk* attracted different type of investors from the Middle East and Asia with 39%, UE with 32% and US with 29% (GSR, 2015).

Another positive trend adopted by certain jurisdictions in many countries is issuing the short term *sukuk* in domestic as well as international markets. This particular strategy and this has already been adopted by Bahrain in 2001. The impetus behind such move was to secure as well as support the liquidity and achieve the required diversity that help meet the needs of the Islamic financial institutions and the continuation of their activities (IIFM, 2014).

Furthermore, the adopting of the determining of the percentage of profits in *sukuk* markets as well as the issuance of *sukuk* at domestic markets in foreign currencies are another practice which has had a positive impact on the development of secondary markets in many countries.

The decline that occurred in *sukuk* issuances in 2014-2015, however, cannot be ignored as the success and development that accompanied *sukuk* markets after the financial crisis in 2008 is considered as well as appreciated. In this regard, it can be said that the decline in *sukuk* issuances can be attributed to the fall in the price of oil on the global level as well as the economic fluctuations at the emerging markets as a result of wars and the so-called Arab spring (GSR, 2015).

Despite such positive development, in recent years a decline has been observed in *sukuk* issuance and the total amount. In 2014, there was somehow a recession in the global *sukuk* issuances compared with 2013, as the value of *sukuk* issued was approximately USD 120 billion compared with USD 138 billion in 2014 as it has been shown in Figure 2.2. It could be argued that the issuances of *sukuk* in 2014 might have been affected by the decrease in the volume of issuance that took place in Malaysian market by nearly 20%, as normally issuances of *sukuk* in Malaysian market accounted for approximately one-third of global issuances. It is also important to note the impact of dramatic decline in the oil prices on *sukuk* market might be long lasting in particular for the GCC countries. The impact of post Arab Spring developments and regional wars in the Middle East should also be considered as reasons of such a relatively poor performance. On the other hand, dramatic increases in the public sector deficit may encourage such countries to issue *sukuk* in the GCC to respond to their public borrowing requirement for infrastructure financing and long-term project in particular through project financing based ‘built-operate-transfer’.

Furthermore, entering of new investors in global *sukuk* markets such as UK and South Africa among others have lessened the negative impact that is attributed to the decline in the international volume of issuance that happened in the Malaysian market due to lack of Malaysian government issuances and also due to the decline in oil revenues (GSR, 2015).

In concluding, the remarkable progress at global *sukuk* markets has a major impact on the development of financial systems in the Muslim countries. Despite the development of the *sukuk* markets and the widespread in both Muslim and non-Muslim countries, the formidable challenges confronting such markets should be taken into consideration. To secure due stability, strength sustainability and transparency in the *sukuk* markets, Islamic institutions such as AAOIFI and IFSB should regulate required relevant laws and standards. This will have its substantial impact on overcoming potential obstacles that impede the application of *sukuk* structures without having negative consequences and risks. Hence, there is indeed a dire need of both new *sukuk* structures to be engineered based on well-established *sukuk* regulations and standards to cope with the spread and flourishing of the *sukuk* issuances in Muslim or non-Muslim jurisdictions.

2.10 RISKS IN *SUKUK*

Sukuk as investment and financing tools are exposed, like other financial instruments, to different type of risks of either financial or non-financial risks. While this research focus on the *Shari'ah* and legal risks as indicated previously, however, it may be appropriate to address an overview of the financial risks that may face the *sukuk* structures as follows;

2.10.1 Credit Risk

Credit risk accrued when there is a failure of the debtor to meet his obligations as this will lead to the situation of loss to the creditor in most cases (Al-Amine, 2008). According to El-Gari (2003) credit risk is the one of the most important types of risks that confront the institutions in their operations that generates assets on the basis of debts and obligations to others

The conventional institution is confronted by the credit risks in almost all its transactions. This is because the relationship between conventional institution and its customers is a continuous debtor and creditor relationship, whatever the nomenclature and the transaction might be. Similarly, the Islamic financial institution is facing this type of risks in most of the models of the financing that it uses. For example, it is a common knowledge that *murabahah* and *Istisnaa'* and *bay' al-taqsit* 'instalment sale' are forward sales that generate debts in the record of the bank. The fundamental risk

in this is the credit risk. Salam contract also generates commodity debts, not cash debt. However, it also involves credit risks. On the other hand, Khan and Ahmed (2001) pointed out that Islamic financial institutions are not confronted with credit risk. This is because there is no credit in the Islamic financial institutions and banks. However, it is confronted with other risks that are known as financing risks, investment risks or operational risks.

2.10.2 Market Risks

According to Al-Amine (2008), the instruments, models or assets that are traded between banks and Islamic financial institutions are a major source of this type of risk. These types of risks arise as a result of the changes that may occur in the macro and micro-economic variables or partial. Market risks cover a wide range which includes the levels of interest rates, exchange rates or commodity prices in certain markets. However, the risk of the changes that occur in interest rate levels is one of the most important market risks that threaten the position of the conventional finance. Thus, since there is close correlation between the rates of profitability in the Islamic strictures and, for example, LIBOR, the changes of the levels of interest rates constitute concrete risks in the performance of the Islamic finance (Ahmad, 2011).

2.10.3 Liquidity Risk

Liquidity risk arises in the situation of the absence of adequate liquidity and necessary operating requirements for routine activities of the Islamic banks, which will reflect negatively in the ability of the banks to meet its cash obligations toward investors and customers (Al-Amine, 2008).

This risk often occurs when there is a huge demand for deposits by depositors, or the financing of long-term loans in the bank by demand deposits or the occurrence of liquidity crisis in the financial market. The occurrence of any of these can be regarded as that the bank is facing liquidity risk (Sayyed, 1999). That is that, its effect on Islamic banks in the case of occurrence of this type of risk is the inability to grant loans or sell debt more than the face value, for the purpose of addressing the liquidity requirements whenever it is needed (Azkari and Iqbal, 2011).

2.10.4 Operational Risks

Operational risks are embodied in the possibilities of the change in operation cost in a very big magnitude more than the expectation, which may cause the decrease in the returns. Operating risks is associated closely with the burdens and the number of departments or branches and the number of staff in the institution. It also includes human error, fraud, forgery, or failure of the system, *etc*. (Tariq, 1999).

In the same vein, operational risk can be caused by various technical errors and accidents, which are often man-made because of insufficient human or technical equipment that are needed on a technical level and also the risks may also be caused by direct or indirect losses at a designated bank (Al-Amine, 2008).

2.10.5 Exchange Rate Risk

These are risks that arise when there are changes in the rate of the exchange between two currencies in an unexpected manner during the intervening period between the processes of decision making on a specific time of payment. The rate of exchange is subject to fluctuations which source might be the changes in interest rate on the assets that are represented by such currency or changes in the centres of the balance of payments or deficits in the budgets of the countries that own the major currencies or in the political events, *etc*. This means that exchange rates fluctuate as a result of economic factors and uneconomic factors. It is not possible, hence, to predict the impacts on the exchange rate. due to this the banking risks of exchange is embodied in the exposure of banks to various risks that are associated with fluctuations in the market levels of currency as a result of its trading in foreign currencies or to use it for the operations that contain payments in foreign currencies (Addel Karim and Archer, 2011).

2.11 CONCLUSION

In the course of this chapter, the emergence of Islamic finance is discussed. In this respect, the Islamic financial principles as well the capital market investments (*sukuk*) global development and trends were explored. Additionally, the structures of different types of *sukuk* are identified and clarified. The next chapter explores developments and trends in Islamic capital market and *sukuk* in Saudi Arabia, which also discusses

the legal and regulative environment and institutions for *sukuk* in Saudi financial market.

Chapter 3

ISLAMIC CAPITAL MARKET AND *SUKUK* IN SAUDI ARABIA

3.1 INTRODUCTION

The Kingdom of Saudi Arabia is considered as one of the most developed and largest economies in the Middle East mainly due to being biggest oil exporter in the world as wealth generated from oil industry has financed the economic development of the country in a rapid manner. Until recent years, the Saudi economy has grown significantly as result of the high oil prices, which is the main determinant of Saudi economy. Consequently, the Saudi government expended increasingly on public and private sector as well as servicing the debt of government which declined to the low level. However, the recent dramatic decline in oil prices has caused concern on the sustainability of the growth of Saudi economy. Since the Saudi economy is largely based on oil exports at the rate about 90%, the decline in oil prices since mid-2014 and its continuation until now will undoubtedly have a negative impact on the Saudi economy. Therefore, there is an urgent need for the Saudi government to diversify its income sources and investment to reduce the risks faced due to the continued decline in the oil price (Aboudah, 2015). Among the sectors are considered to be affected by the declining oil prices include Saudi Islamic banking and finance (IBF) sector and in particular *sukuk* market.

Although the Islamic finance sector has made considerable progress to become a well-established sector in Saudi Arabia and around the world, the recent liquidity issues due to the declined oil revenues has caused concern for the sustainability of the sector. Despite this, the failure of conventional banks to cope with the recent global financial crisis in 2008 strongly favours the IBF as to provide a potential solution for the worldwide economic crisis. In other words, the model of IBF with its ethical philosophy in basing on a ‘sharing’ economy philosophy could provide a real alternative for millions of Muslim as well as non-Muslim customers around the world (Al-Darwish *et al.*, 2015).

As regards to the potential role of IBF in Saudi Arabia, there are real prospects for the industry to grow through developing new products including Islamic capital markets such as *sukuk* and through attracting more customers, particularly in the Saudi market

which could become the world leading country in the area of IBF. Accordingly, it can be argued that the main factors that can be the reasons for the recent development of the IBF market in Saudi Arabia are the size of the local economy as well as the environment of the IBF in Saudi Arabia (NCCR, 2011). Thus, given its flourishing economy coupled with its approximately 100% Muslim population; Saudi Arabia has good prospects in terms of its Islamic financial industry especially in *sukuk* market as it can be seen in Figure 3.1.

However, compared with many Muslim and non-Muslim countries around the world including the GCC, Saudi Arabia is considered one of the top economies in the world. According to Ramady (2010), Saudi Arabia maintains a stable steady economic growth giving the country the edge as a potential promoter of the Islamic finance industry. In this respect, some of the top Islamic financial institutions among 500 Global IBFs around the world in 2015 were based in Saudi Arabia as illustrated in Table 3.2 (The Banker, 2015), which will make significant contributions to the development of the Islamic finance industry through their *Shari'ah*-compliant assets. In addition, the Saudi market has become globally one of the biggest markets in terms of *Shari'ah*-compliant assets matching countries such as Malaysia and Iran in the Muslim world (The Banker, 2015). Therefore, the IBF sector in Saudi Arabia has been a great advantage for the country given the profitability and stability of the associated financial institutions, not to mention the prospects for future economic growth especially in the *sukuk* market giving it a competitive advantage worldwide. Therefore, the Saudi regulators as well as the decision makers should provide a well-established market for the continuous promotion of the IBF industry.

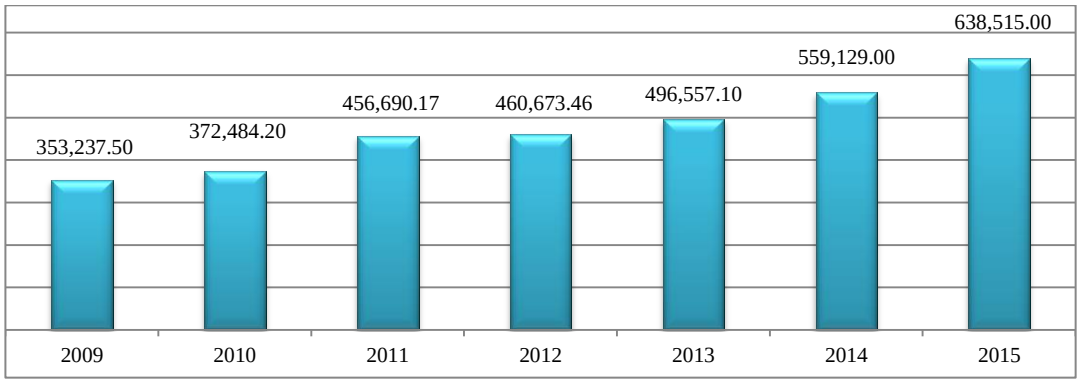
This chapter, hence, aims to identify the developments and trends in IBF industry in Saudi Arabia, which also aims to present the regulative and legal environment in relation with IBF development in the country. This chapter, hence, serves a foundational chapter for the empirical chapters later in the thesis.

3.2 ISLAMIC FINANCE ENVIRONMENT IN SAUDI ARABIA

Saudi Arabia has been the last country within the GCC to develop and implement strategies to develop its IBF sector, which has been strongly opposed in the early stages by many Arab countries. While initially the use of small amounts of investment funds provided by the GCC states to develop a small IBF industry (Henry and Wilson,

2004), the establishment of the IDB, as a pan-Islamic bank for the Muslim World in Saudi Arabia in 1974 under the auspices of the Organisation of the Islamic Conference – or as known now Organisation for Islamic Cooperation - (OIC) marked the begging of the IBF activities in Saudi Arabia. One of the main purposes of the IDB has been promoting the socio-economic development in the Islamic world in general and in member states in particular in accordance with *Shari'ah* principles. Thus, the IDB has provided financial assistance to many countries in the Muslim world (Iqbal, 2007). The developments and trends in the GCC IBF industry in terms of asset size growth are depicted in Figure 3.1, which substantiates the success of the sustainable growth.

Figure 3.1: Total *Shari'ah* Compliant Assets in the GCC (2009-2015) ($M)



Source: The Banker (various issues)

The evolution of the IBF sector in Saudi Arabia featured the introduction of *Shari'ah*-compliant transactions into a number of several conventional banks, whereby *Alrajihi* Banking and Investment Corporation was the first to transform its activities to become consistent with *Shari'ah* law (Khan and Bhatti, 2008). That move was followed by *Alahli* Trade Fund established by the National Commercial Bank (NCB) to become the first *Shari'ah*-compliant fund in the country (Wilson, 2009). In 1992, a specialized department was established by National Commercial Bank to provide supervision to its *Shari'ah*-compliant branches (NCCR, 2011). Then, other banks soon followed suit whereby in 1995 the Saudi-Hollandi bank established the department of IBF, and Saudi Financial Group set the Islamic banking services in 1996. As part of the developments, *Al-Jazerah* bank in 1998 approved its strategic plan to transform itself gradually into an Islamic bank by the end of 2005. The bank of *Al-Riyadh* also managed to open an Islamic window in 2000 before establishing its first Islamic branch in 2003. This trend was followed by *Al-bilad* and *Al-inma* banks, which were

established in 2004 and 2008, respectively, to raise the number of Islamic banks in Saudi Arabia to four Islamic based banks (NCCR, 2011). Despite the fact that the international financial market has been badly hit by financial crisis, the crisis has provided a good opportunity for the IBF in Saudi Arabia to fill the gap that has been created by the troubled institutions in Western countries even though the former have to cope with many challenges ahead. In fact, the Saudi financial markets could manage to overcome the financial crisis through enhancing customers' confidence in the Islamic finance as well as improving liquidity in the debt markets.

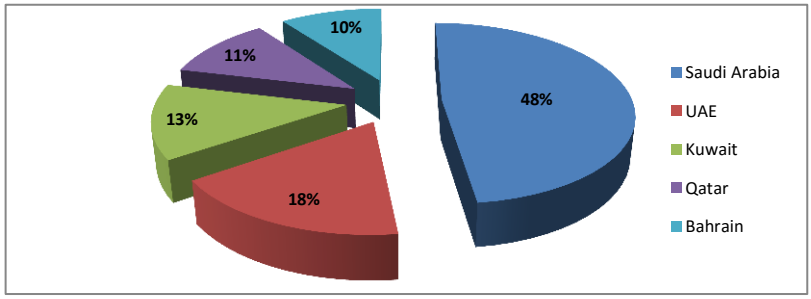
In terms of the market size and trends, the *Shari'ah*-compliant assets have grown and increased significantly in recent years in the GCC (The Banker, 2015). As depicted in Table 3.1 and Figure 3.2, Saudi Arabia has the largest IBF market in the GCC so far with total USD 306,807million, which is considered the second market compared to Iran (USD 316.423 million) in terms of *Shari'ah*-compliant assets (The Banker, 2015). In a comparative perspective with other GCC countries, Saudi Arabian *Shari'ah* compliant assets grew by approximately 135% over 2009-2015 periods as it can be seen in Table 3.1. While in the same period, Qatar's Islamic finance assets grew by almost 260% despite the Saudi Arabian Islamic assets are the largest in the region.

Table 3.1: Developments and Trends in *Shari'ah* Compliant Assets in the GCC, 2009-2015 ($M)

Country	2009	2010	2011	2012	2013	2014	2015	% Increase 2009-2015	GCC Ranking 2015	World Ranking 2015
KSA	127,896.1	138,238.5	150,945	185,223	227,173.72	257,054	306,807	139%	1	**2**
UAE	84,036.5	85,622.6	94,126.66	89,390.38	87,321.58	105,780	111,294	32%	2	**4**
Kuwait	67,630.2	69,088.8	79,647.85	78,587.25	72,464.97	80,448	84,448	24%	3	**5**
Qatar	27,515.4	34,676.0	52,322.38	45,301.30	53,125.16	59,254	70,898	157%	4	**6**
Bahrain	46,159.4	44,858.3	79,647.85	62,171.53	56,471.67	56,593	65,068	40%	5	**7**

Data Source: The Banker (various issues)

Figure 3.2: Total *Shari'ah* Compliant Assets in the GCC (2009-2015) ($M)



Data Source: The Banker (various issues)

In terms of individual Saudi Arabian Islamic banks, as it can be seen in Table 3.2, *Al-Rajihi* Bank has the largest Islamic assets totalling around USD 82,056.41 million in 2015 an equivalent of almost one third of the total assets of banking market in Saudi Arabia, as the *Alrajihi* Bank is considered as the top bank among 500 global institutions that have *Shari'ah*-compliant assets during 2015 (The Banker, 2015). Moreover, 12 Saudi IBF institutions among the Top 50 Financial *Shari'ah*-compliant assets institutions are based in Saudi Arabia as shown in Table 3.2. This can be an indication for success and progress of the Islamic financial market in Saudi Arabia.

Table 3.2: The Top Financial Institutions in Saudi Arabia with *Shari'ah*-Compliant Assets, 2009-2015

Institution	*Shariah*-Complaint Assets $M - 2009	*Shari'ah*-Complaint Assets $M - 2010	*Shari'ah*-Complaint Assets $M –2011	*Shari'ah*-Complaint Assets $M –2012	*Shari'ah*-Complaint Assets $M –2013	*Shari'ah*-Complaint Assets $M –2014	*Shari'ah*-Complaint Assets $M –2015	Rank in 2015
Alrajihi Bank	43,981.3	45,527.9	49,290.9	58,883.0	71,302.0	74,632	82,056.41	1
National Commercial Bank	16,135.5	17,112.5	18,676.0	21,591.2	27,794.4	33,106	46,366.61	4
Saudi British Bank	12,288	11,198.0	9,339.7	14,721.9	17,202.7	20,981	44,022.13	13
Alinma Bank	4,430.1	6,652.7	8,665.9	9,808.0	14,403.0	16,800	21,563.00	16
Samba Financial Group	6,351.4	6,151.7	7,865.1	9,544.8	12,729.1	14,625	18,393.87	19
Riyadh Bank	10,809.1	11,912.5	12,080.3	14,018.4	15,151.5	17,043	18,188.00	21
Benque Saudi Fransi	7,102.1	8,124.8	8,866.1	11,926.4	14,210.7	16,652	17,915.47	22
Bank Al Jazirah	7,338.6	7,993.8	8,804.9	10,382.0	13,588.0	15,993	17,747.00	23
Arab National Bank	8,933.3	8,505.7	9,040.0	10,586.0	13,146.7	14,080	17,626.67	24
Albilad Bank	4,280.4	4,643.0	5,631.1	7,393.0	7,940.0	9,686	12,061.00	31
Saudi Holandi Bank	2,982.4	3,052.3	3,613.3	3,653.3	5,413.6	6,485	8,560.00	43
Saudi Investment Bank	333.1	2,520.3	2,931.5	3,064.3	4,038.9	6,201	8,158.13	45
Islamic Development Bank	1,791.5	2,326.8	2,428.7,	2,760.3	3,036.6	2,239	3,946.38	69
The Company for Co-operative Insurance (NCCI)	732.2	1,927.3	2,008.4	1,969.0	2,191.4	2,657	2,650.27	80

Data Source: The Banker (various issues)

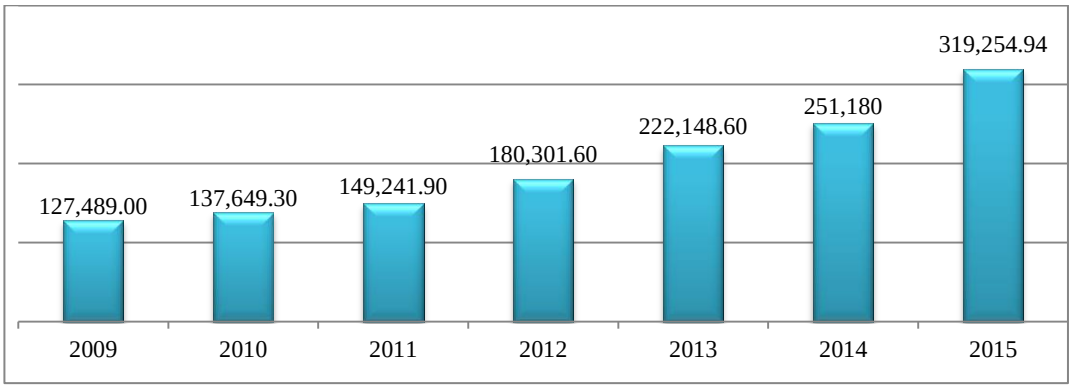
Table 3.2a: Percentage Share of the Assets of Top Islamic Financial Institutions in Saudi Arabia to Assets of Total Banking Sector and Islamic Banking Sector, 2009-2015

Percentage of Individual Islamic Bank Assets to Banking Sector Total Assets							
Institutions	2009	2010	2011	2012	2013	2014	2015
Alrajihi Bank	0.12	0.04	0.04	0.04	0.05	0.05	0.06
National Commercial Bank	0.05	0.01	0.02	0.02	0.02	0.02	0.03
Saudi British Bank	0.03	0.01	0.01	0.01	0.01	0.01	0.03
Alinma Bank	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Samba Financial Group	0.02	0.01	0.01	0.01	0.01	0.01	0.01
Riyadh Bank	0.03	0.01	0.01	0.01	0.01	0.01	0.01
Benque Saudi Fransi	0.02	0.01	0.01	0.01	0.01	0.01	0.01
Bank Al Jazirah	0.02	0.01	0.01	0.01	0.01	0.01	0.01
Arab National Bank	0.02	0.01	0.01	0.01	0.01	0.01	0.01
Albilad Bank	0.01	0.00	0.00	0.01	0.01	0.01	0.01
Saudi Holandi Bank	0.01	0.00	0.00	0.00	0.00	0.00	0.01
Saudi Investment Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.01
Islamic Development Bank	0.01	0.00	0.00	0.00	0.00	0.00	0.00
The Company for Co-operative Insurance (NCCI)	0.002	0.002	0.002	0.001	0.002	0.002	0.002
Percentage of Individual Islamic Banking Assets to Islamic Banks' Total Assets							
Institutions	2009	2010	2011	2012	2013	2014	2015
Alrajihi Bank	0.16	0.16	0.15	0.16	0.18	0.17	0.18
National Commercial Bank	0.06	0.06	0.06	0.06	0.07	0.08	0.10
Saudi British Bank	0.04	0.04	0.03	0.04	0.04	0.05	0.10
Alinma Bank	0.02	0.02	0.03	0.03	0.04	0.04	0.05
Samba Financial Group	0.02	0.02	0.02	0.03	0.03	0.03	0.04
Riyadh Bank	0.04	0.04	0.04	0.04	0.04	0.04	0.04
Benque Saudi Fransi	0.03	0.03	0.03	0.03	0.04	0.04	0.04
Bank Al Jazirah	0.03	0.03	0.03	0.03	0.03	0.04	0.04
Arab National Bank	0.03	0.03	0.03	0.03	0.03	0.03	0.04
Albilad Bank	0.02	0.02	0.02	0.02	0.02	0.02	0.03
Saudi Holandi Bank	0.01	0.01	0.01	0.01	0.01	0.01	0.02
Saudi Investment Bank	0.00	0.01	0.01	0.01	0.01	0.01	0.02
Islamic Development Bank	0.01	0.01	0.01	0.01	0.01	0.01	0.01
The Company for Co-operative Insurance (NCCI)	0.003	0.007	0.006	0.005	0.006	0.006	0.006

Data Source: The Banker (various issues); Bankscope

As depicted in table 3.2, while Islamic banking asset size demonstrated a growth, as shown in Table 3.2a its share in the total banking asset size seems to be decreasing. This implies that in Saudi Arabia, conventional banking asset size has been increasing with a higher pace compared to Islamic banking asset size.

Figure 3.3: The Development of the *Shari'ah*-compliant Assets in the Top 14 Institutions in S.A, 2009-2015 ($M)



Data Source: The Banker (various issues)

In addition, the increasing in the *Shari'ah*-complaint assets in all financial institutions in Saudi Arabia, which represent a high demand for Islamic financial services, can also be seen in the Figure 3.3, which indicates a gradual increase. This shows that there is a potential need to make the Islamic financial sector in SA more sophisticated, regulated and profitable.

3.3 *SUKUK* MARKET IN SAUDI ARABIA

Saudi Arabia has recently witnessed an unprecedented economic growth through supporting the expanding monetary and financial policies (Ramady, 2010). In addition, it has resorted to ambitious expansionary fiscal and monetary initiatives in responding to the concerns stemmed from the international financial crisis and Arab spring. The impact of these policies has been reflected in the figures of gross domestic product (GDP) of the country in the last five years (Iqbal and Bin Zarah, 2013).

Government expenditure, initiatives for reforming fiscal policies, promulgation of new laws and regulations, availability of adequate liquidity, all these are factors that have contributed to the expansion of the financial market for *sukuk* and bonds that will meet the needs of public and private sector in Saudi Arabia (Al Elsheikh and Tanega, 2011). In consideration of the notable expansion in the activities of companies, whose policies necessitate provision of liquidity without exposing shares holders to *Shari'ah* and financial risks, big companies including Aramco, SABIC and Saudi Electricity *etc*. have dealt with *sukuk* as one of the important financing methods. In this respect, it should be mentioned that sustaining efforts are being made by the CMA in Saudi Arabia to develop an efficient capital market. However, those

efforts culminated in the approval to promote the Saudi Stock Exchange Company (*Tadawul*) to join the annual meeting of the World Federation of Exchanges convening on 6th October 2009 in Vancouver, Canada. As a qualified member of the meeting, *Tadawul* was expected to provide its customers with new financial products and services including an online market for *sukuk* and bonds commencing on 13th June 2010. The new electronic market *Tadawul* features with various services includes *sukuk* listing to pricing information. As for *sukuk* and bonds in the new market; they would be traded through licensed brokerage firms that would use an investment portfolio similar to that used for stock trading (CMA Web, 2013).

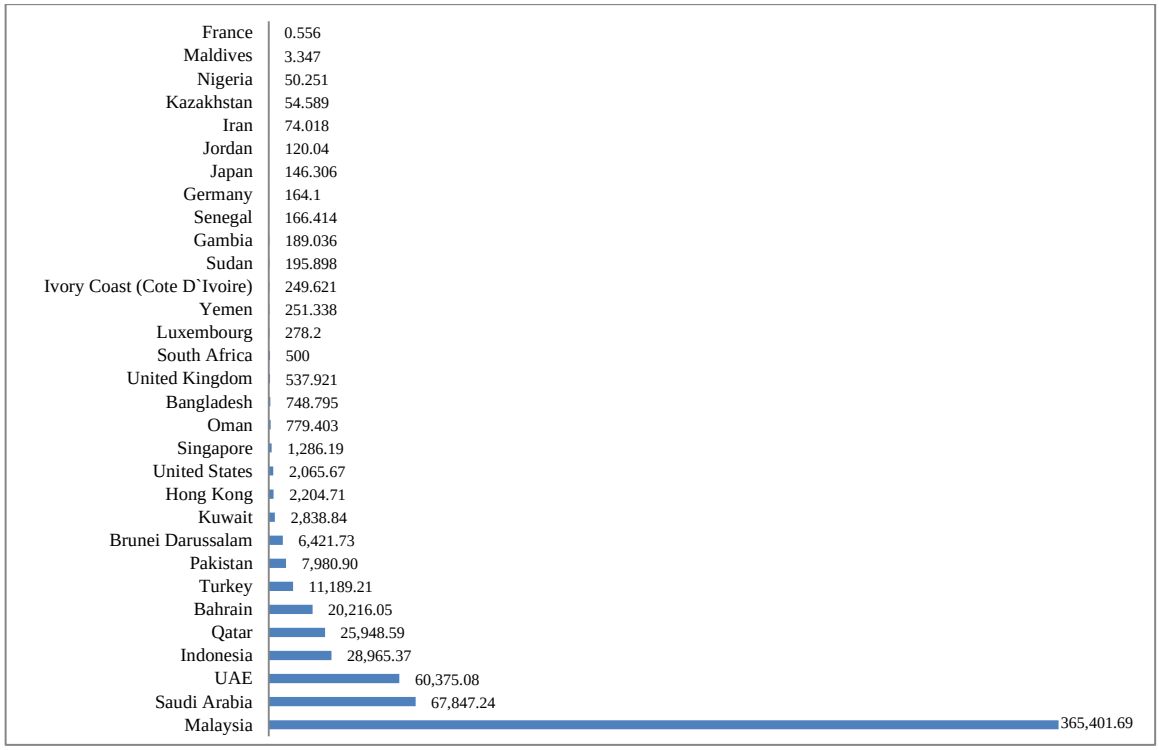
It could be argued that in the aftermath of the Saudi stock market crunch in 2006; and coupled with global financial crisis; investors have become aware of the secure approach of investment by focusing on *sukuk* as more realistic and predictable asset in terms of risk management (Al Elsheikh and Tanega, 2011). However, despite the limited options for investment in Saudi Arabia, *sukuk* could become a main player in portfolio diversification as result of the *Shari'ah* objections of raising finance from conventional interest-based sources. As a matter of fact, bank loans and initial public offering constitute the main source for financing companies in the Saudi market. Nonetheless, with dwindling bank loans and inadequate initial public offerings, *sukuk* can become as an alternative financing method for funding companies. However, it should be noted with concern that, the financial crisis in the stock market in 2006 in Saudi Arabia made the (conventional) financial market less attractive to investors (Ramady, 2010). Therefore, the major Saudi companies include ARAMCO, SABIC, SADARA *etc*. considered *sukuk* as a potential method for finance in the face of the financial meltdown in the conventional sector.

However, it is noteworthy that the *sukuk* market has made a major contribution to the trading activities. In this respect, the website of the *Tadawul*, which is based on CMA provides information relevant to the *sukuk* market as to enhance transparency, and in effect, this will attract more customers to the *sukuk* market. However, there is no limit on *sukuk* prices, with the tick size unit equivalent to 0.001 % of the *sukuk* value, and that the *sukuk* market remains open from 11.30 am to 3.00 pm from Sunday to Thursday every week.

3.3.1 Evaluating *Sukuk* Market In Saudi Arabia

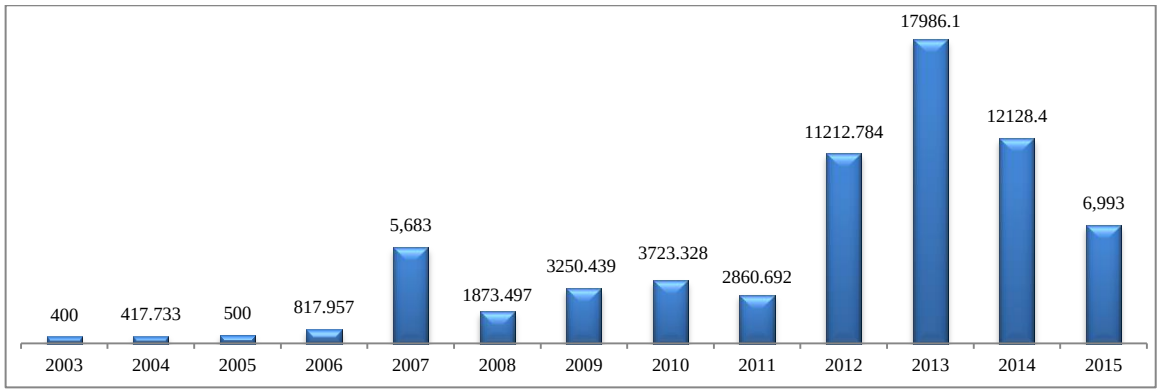
As can be seen from the Figure 3.4, the *sukuk* issued in Saudi Arabian market since 2003, making the Saudi Arabian market the second largest *sukuk* market globally, while Figure 3.5 depicts the increasing trends in the *sukuk* markets.

Figure 3.4: Total Size of *Sukuk* Issuances, 2001-2015 ($M)



Source: Zawya (2015)

Figure 3.5: Trends in Saudi Arabian *Sukuk* Market, 2003-2015($M)



Source: IFIS Database (2013); *Zawya* Database (2015) and *Tadawul* Database (2015)

The total value of *sukuk* issuances in Figure 3.5 shows a sustained growth in the Saudi *sukuk* market. The growth in *sukuk* value managed to overtake the pre-global financial

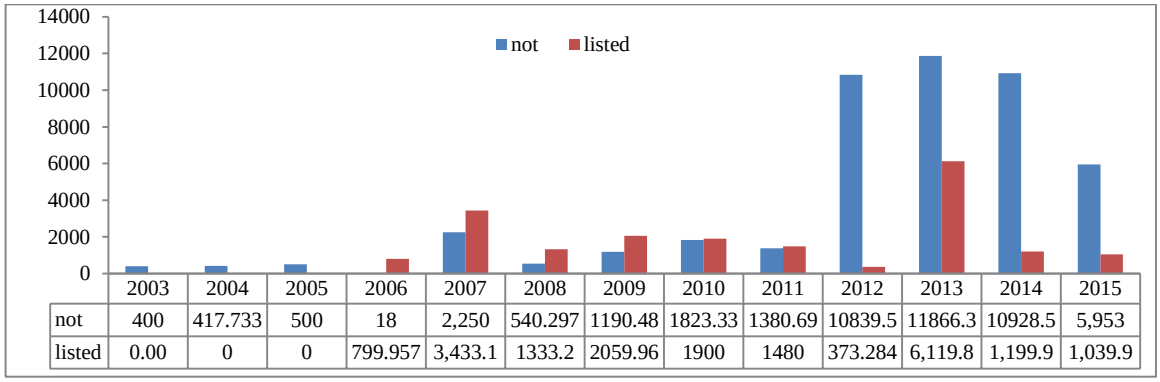
period in 2012. After reaching its peak in 2013, the decline in the oil prices have shown its impact in 2014 and 2015 by decreased *sukuk* value.

Thus, as regards the local Saudi *sukuk* market, it is considered inactive as the issuances of *sukuk* are not frequent as it can be seen in Figure 3.7. However, since 2012, a significant increase in the number of *sukuk* issuances has been observed, which reached approximately 23 in 2013. The estimated value in 2013 was approximately USD 18 billion as is depicted in figure 3.5.

As can be seen in Figure 3.6, in 2014, the value of *sukuk* issued declined by approximately 30%, although, the number of *sukuk* issued in the same year were almost the same. However, the KSA *sukuk* market witnessed in 2015 a sharp decline of the value of *sukuk* issuances with approximately 65% as it has been shown in Figure 3.5. This can be as consequences of the low prices of oil as it has been mentioned above.

As can be seen in Figure 3.6, the Saudi Arabian *sukuk* market, there are around 106 issuances of *sukuk* between 2003-2015 with an approximate total value of USD 67,847.22 million.

Figure 3.6: *Sukuk* Market Trends in Saudi Arabian Market (*Sukuk* Issuances (Listed and Not Listed in *Tadawul*), 2003-2015 ($M)

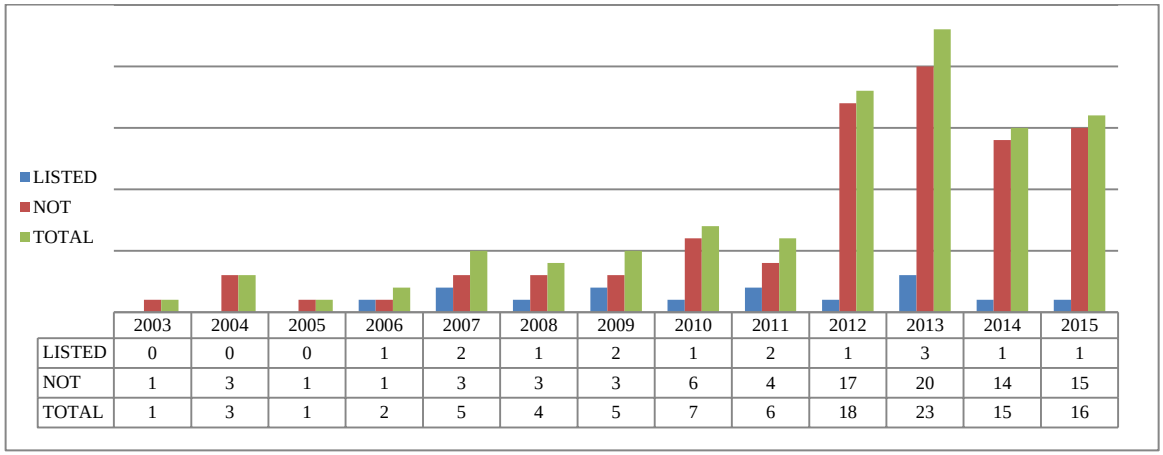


	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
not	400	417.733	500	18	2,250	540.297	1190.48	1823.33	1380.69	10839.5	11866.3	10928.5	5,953
listed	0.00	0	0	799.957	3,433.1	1333.2	2059.96	1900	1480	373.284	6,119.8	1,199.9	1,039.9

Data Source: IFIS Database (2013); Zawya Database (2015); *Tadawul* Database (2015)

The Saudi Arabian domestic *sukuk* market is divided into two sections; one for the *sukuk* listed in the *Tadawul* which are considered as public issuances. Another type of domestic *sukuk* market is located for *sukuk* that are not listed in the *Tadawul,* which are issued as private issuances. As can be seen in Figure 3.7, 29% of the total *sukuk* were being listed in *Tadawul* in comparison with 71% were being not listed as it can be seen in Figure 3.7 and Figure 3.8.

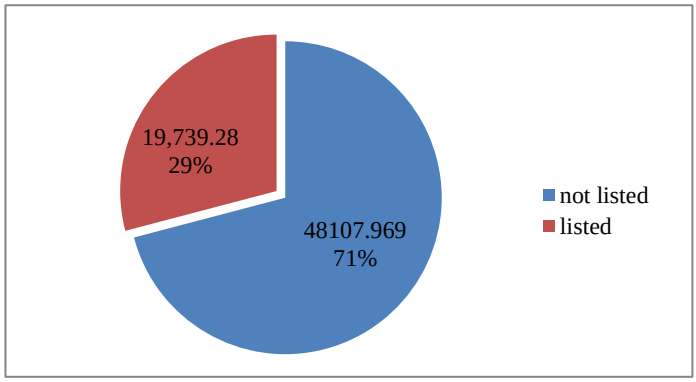
Figure 3.7: The Number of (Listed-Not Listed) *Sukuk* Issued in S.A, 2003-2015



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
LISTED	0	0	0	1	2	1	2	1	2	1	3	1	1
NOT	1	3	1	1	3	3	3	6	4	17	20	14	15
TOTAL	1	3	1	2	5	4	5	7	6	18	23	15	16

Data Source: IFIS Database (2013); Zawya Database (2015); *Tadawul* Database (2015)

Figure 3.8: The Total Value of (Listed-Not Listed)*Sukuk* Issued in S.A,2003-2015



Data Source: IFIS Database (2013); Zawya Database (2015); *Tadawul* Database (2015)

In Saudi Arabia while *sukuk* market is still being inactive, 15 *sukuk* have been issued and listed in *Tadawul* since the establishment of the *sukuk* market by a few companies. It is worth mentioning that the value of all listed *sukuk* presented in *Tadawul* was approximately USD 19,736 million as it can be seen in Figure 3.6 and 3.7. While the details of all listed *sukuk* can be reviewed on *Tadawul* website, 91 *sukuk* issuances were not listed in *Tadawul* making the value worth approximately USD 48,107 million as identified. This indicates the inactiveness of the Saudi *sukuk* market as result of the preference of the Saudi companies to not to list their *sukuk* in the *Tadawul* and rather opting for private placements.

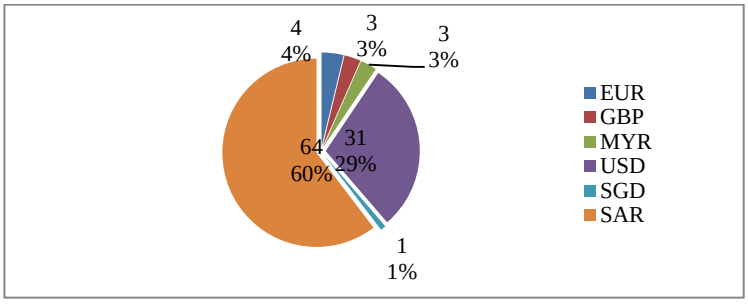
In this regard, Rabindranath and Gupta (2010) note that despite all the development and changes that have been made by the government, the market activity for *sukuk* remains modest in Saudi Arabia. In their opinion, the small number of listed *sukuk* compared to not listed issuances could be explained by the high annual registration

fees with *Tadawul* amounting to USD 27,000 plus a further USD 13,000 for uploading issuances. According to the Collaborative *Sukuk* Report (2010), the high registration costs tend to make foreign investors closely examine the economic feasibility of *sukuk*, not to mention the fact that it constitutes a major deterrent for other companies to issue such financial instruments.

As a matter of fact, the progress of *sukuk* market in Saudi Arabia can be hampered by the inadequacy of the local rating agencies, thus, complicating the process of assessing the risk involved with such investment. For that reason, investors always go for initially rated securities; as such securities can be attainable in terms of risk management (Al Elsheikh and Tanega, 2011). Currently, ratings can be done by foreign agencies even though several companies could find the costs unaffordable to them. Nonetheless, according to Rabindranath and Gupta (2010) foreign agencies use foreign markets as a reference; this is a disadvantage for Saudi market. Moreover, Al Elsheikh and Tanega (2011) point out that complexities involving *sukuk* may negatively affect risk assessments in relation to *sukuk* market. At the present, the situation has favoured Islamic banks, as the restrictions on debt issuance tend to increase demand for *sukuk* (Wilson, 2009). This might destabilise prices of any new generation of *sukuk* that might be issued in Saudi Arabia as banks might fail to get the *sukuk* they yearn for. Another concern is that only a few long-term *sukuk* will be available in the market despite their importance for long-term investment, particularly for pension purposes.

In reflecting on the jurisdictions, the Saudi *sukuk* market can be divided into two categories: locally issued *sukuk* SAR and the second category is the international issuance of *sukuk* denominated mostly in USD. In this respect, SAR accounts for 60% of the issuances, while USD issued *sukuk* accounts for 29% comparing to other currencies in Saudi Arabian *sukuk* market, which is depicted in Figure 3.9.

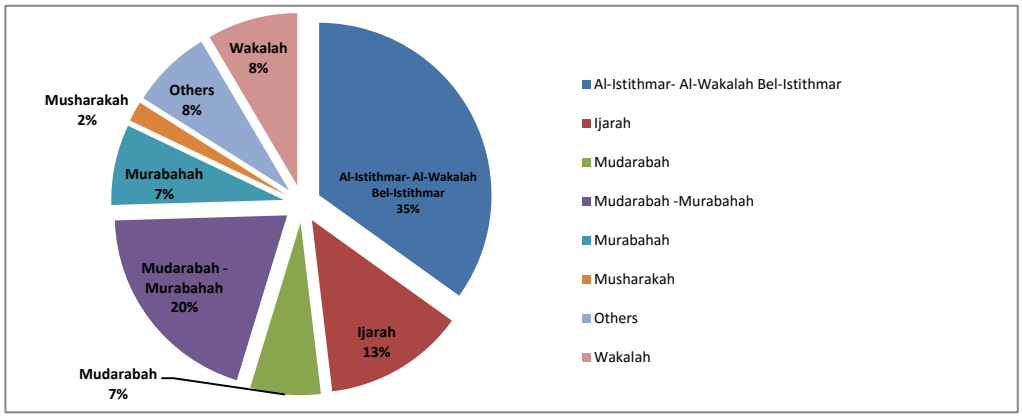
Figure 3.9: Saudi Arabian *Sukuk* by Issuance Currencies, (2003-2015)



Data Source: IFIS Database (2013); Zawya Database (2015); *Tadawul* Database (2015)

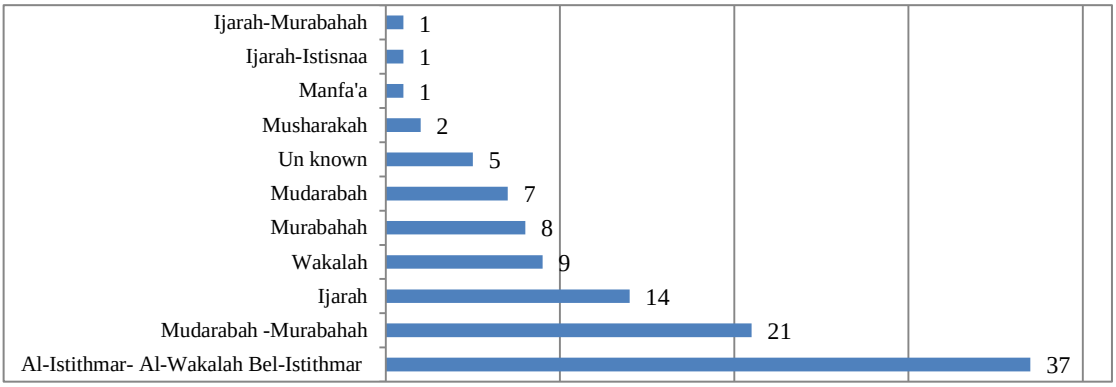
Regarding the most used structures since the first *sukuk* issued in the Saudi *sukuk* market, *sukuk al-istithmar* structure with 35% of the total issuances has been the most popular structures, as it can be seen in Figure 3.10 and Figure 3.11. In addition, *mudarabah* with *murabahah* based structure and *ijarah* are also considered another most used structure, which have chosen by the issuers among another structures in the Saudi Arabian market with 27% and 20% respectively.

Figure 3.10: Saudi Arabian *Sukuk* Breakdown by Type of Structures, 2003-2015



Data Source: IFIS Database (2013); Zawya Database (2015); *Tadawul* Database (2015)

Figure 3.11: Saudi Arabian *Sukuk* by Number of Structures, 2003-2015



Data Source: IFIS Database (2013); Zawya Database (2015); *Tadawul* Database (2015)

On the other hand, the first sovereign *sukuk* issued in the Saudi Arabia market was the *sukuk* issued by the General Authority of Civil Aviation (GACA) in 2012 guaranteed by the Ministry of Finance of Saudi Arabia with total value of USD 4,000 Million. This issuance was followed by the second sovereign *sukuk* issuance of GACA, which is considered as the largest issuance in the Saudi market with total value of USD 4,055.94 million, as it can be seen in Table 3.3 (see the end of the Chapter). In addition, SABIC Company issued three issuances with total value of USD 4,233.157 million. These *sukuk* were also considered one of the largest issuances in the Saudi

domestic market. All the *sukuk* issued in Saudi Arabian *sukuk* market whether by number, issuer, issue date, type of *sukuk* or currency, between 2003 and 2015 can be seen in Table 3.3.

Since IDB is based in Saudi Arabia, its *sukuk* activities should also be considered. However, IDB adopts general trend to issue *sukuk* at the international level rather than domestic market. According to Zawya database (2015), the numbers of *sukuk* issued by IDB were 22 issuances with total value of USD 12,389.5 million. In addition, *Dar al-Arkan* is considered also one of the prominent issuers of *sukuk* at the international level with 7 issuances worth approximately USD 3,400 Million.

It should be mentioned that the international *sukuk* issued in the Saudi Arabian market is characterised by two features according to Iqbal and Bin Zarah (2013). The first feature is that *sukuk* issued in Saudi market are classified and rated either according to the solvency of the issuer or based on the issuance itself. This classification can help the investor to be familiar with the regulations and policies of the Saudi market. The second characteristic for the international issuances in the Saudi Arabian market is that most of the international *sukuk* were being listed in foreign exchanges. These two features will encourage investors to deal easily with their *sukuk.*

As regards to the most of the structures used in the international *sukuk* issuances, the *sukuk al-wakalah bel-istithmar* and *ijarah* are considered the most used structures in the KSA market.

It can be said that the idea of *sukuk* in the Saudi market emerged as an Islamic substitute for interest-based bonds. Therefore, most Saudi companies as well as some banks in Saudi Arabia adopted the *sukuk* as method for securing long-term financing for their expansion as the *sukuk* is considered one of the most applicable finance approaches. This tendency has had a significant impact on the remarkable progress in the Saudi *sukuk* market.

Although, there were a significant efforts offered through CMA for the purpose of the development of the Saudi *sukuk* market, various *Shari'ah* and legal obstacles still need to be resolved. In this regard, it could be argued that one of the challenges, which can affect the development of the *sukuk* market in the country, is the credit rating for *sukuk*. Most companies in financial market consider the solvency of the

issuer (credit classification) as the main issue that should be taken into account when they tend to involve into any financial transaction, especially credit-based transactions. In this respect, it can be said that credit rating strategy has now become a source of guarantee for attracting investors particularly in the financial markets. Through this kind of method, the solvency of any issuer can be recognised.

In Saudi Arabian *sukuk* market, international *sukuk* issuances dominated in foreign currency are usually rated by special agencies, as the credit rating is crucial for investors, as it has been noted above. However, the domestic *sukuk* issuances dominated in Saudi Riyal are still not rated, which is justified on the ground that there is no urgent need for the issuances of *sukuk* to be rated. This can be supported by the large demand for *sukuk* issued in the Saudi domestic market even though those *sukuk* were not-rated. Additionally, the number of *sukuk* issued in the Saudi *sukuk* market are limited compared to the liquidity in the Saudi market which created a large demand for investment in *sukuk*, even if they are not rated. Furthermore, it can also be stated that most of the Saudi companies issued *sukuk* are considered well-known companies among the investors in terms of their solvency as well as their activities. This reputation can be considered as a benchmark for investors. However, the recent entry of foreign companies to the Saudi Arabian market may have positive impact on the CMA's regulations as well as motivating the *sukuk* issuers to consider their *sukuk* to be rated. Thus, the credit rating has become an urgent need and an important factor in the Saudi *sukuk* market. This trend will attract *sukuk* investors, as it will provide them the transparency of the issuer.

Despite the success in the Saudi *sukuk* market, in 2015, the total number of transactions recorded in the *Tadawul* was only 20 transactions according to *Tadawul* web, which is comparatively very small compared to other financial markets as the shortage of the issuances and lack of frequent transactions can be resulted in undermining the confidence of *sukuk* investors whether locally or internationally. While the decline in oil based liquidity and economic impact can be considered for the decrease, considering the need for project financing in the country, *sukuk* should be considered as an important instrument.

In this regard, a number of suggestions can be made to improve the Saudi Arabian *sukuk* market. Increasing the sovereign *sukuk* is one of the solutions, as it will create a

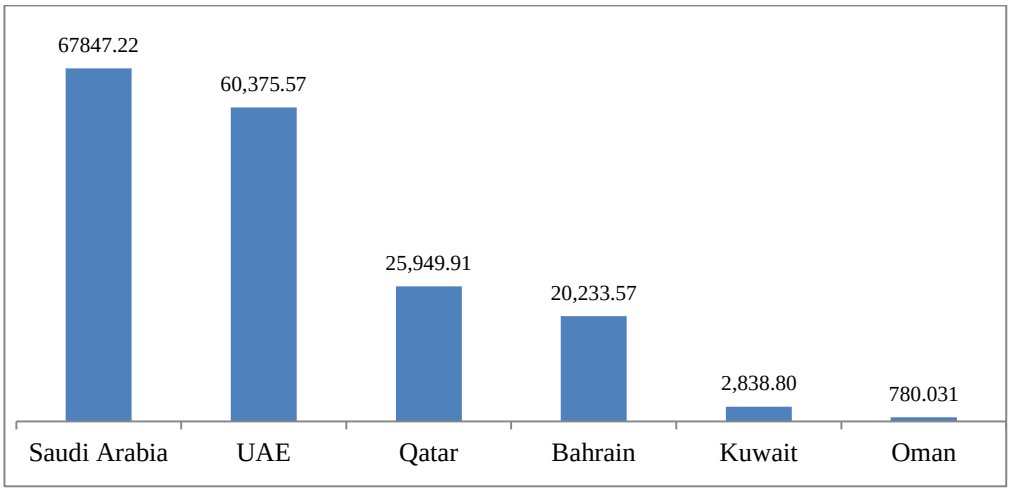
solid platform and a yield curve in the *sukuk* market. Enhancing the transparency in the Saudi Arabian market from the beginning of the issuance to the time of maturity has become also essential particularly pricing the value of *sukuk*. There are many other factors, which will be discussed in details in Chapter 6 and Chapter 7.

3.3.2 Comparing the Saudi Arabian and the GCC *Sukuk* Markets

Sukuk markets in the GCC have grown rapidly in the last few years with deferent type of issuances include sovereign and quasi-sovereign as well as corporate issuances. Therefore, it is considered one of the largest global *sukuk* markets.

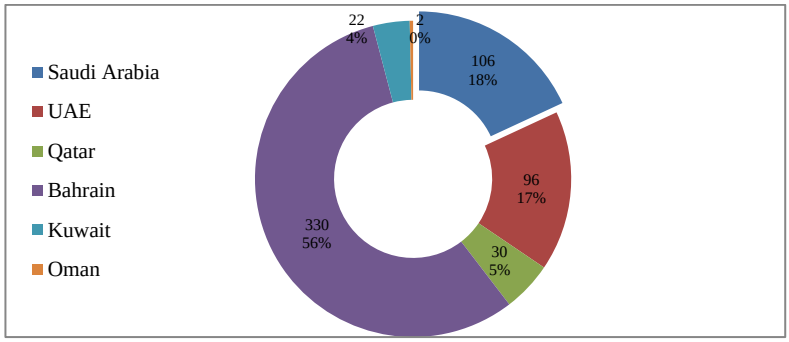
As can be seen in Figure 3.12, Saudi s*ukuk* market is considered as the leader market in the GCC with an approximate total *sukuk* value of USD 67,847.22 million. The UAE with total value of USD 60,375.57 million is the second market in the GCC, as it has been indicated in Figure 3.12. However, Omani market is the last among the GCC markets with an approximate total value of USD 780.031 million. This can be justified by the late entering of the Oman in the *sukuk* market, as it has been noted above. In terms of the number of issuances, the Bahraini *sukuk* market is considered the active market in the GCC with 330 issuances representing 56% of the total issuances in the GCC markets. This followed by Saudi Arabia and the UAE market with106 and 96 issuances respectively as it can be seen in Figure 3.13. As depicted, Saudi Arabian *sukuk* market accounts for nearly 13% of the number of *sukuk* as compared to other GCC markets. In terms of the value, the Saudi market accounts for 37% of *sukuk* in the region as it can be seen in Figure 3.14.

Figure 3.12: Total Value of *Sukuk* Issued in the GCC, 2003-2015 ($M)



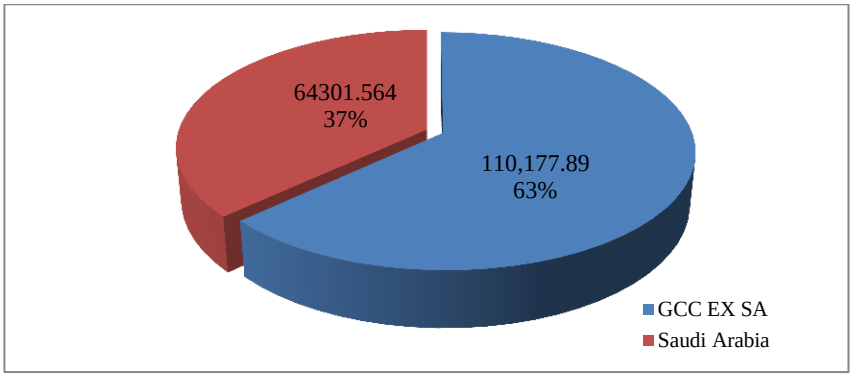
Data Source: Zawya Database (2015)

Figure 3.13: Total Number of *Sukuk* Issued in the GCC, 2003-2015



Data Source: Zawya Database (2015)

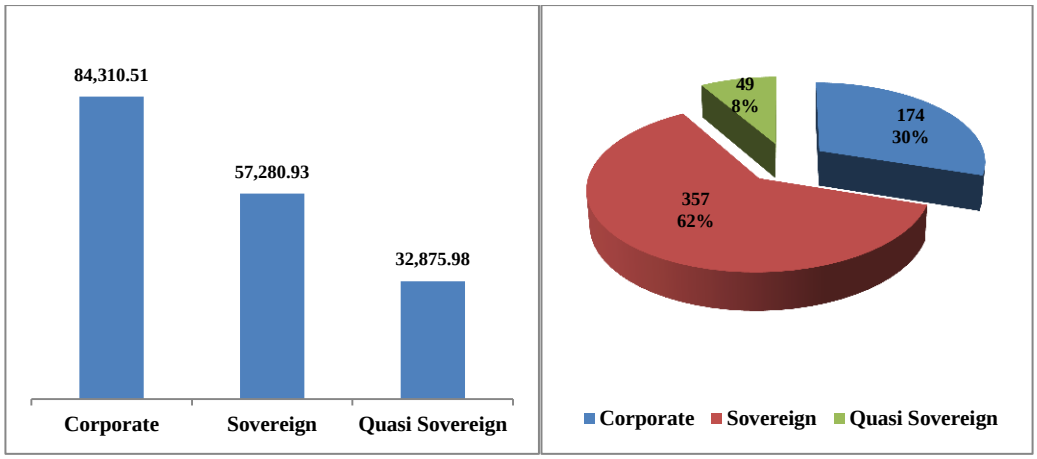
Figure 3.14: Comparison of S.A Market to the GCC Markets, 2003-2015 ($M)



Data Source: Zawya Database (2015)

As for the type of the type of issuance, corporates are considered the most issuers of *sukuk* in the GCC market followed by sovereign *sukuk* as it is illustrated in Figure 3.14. As regards to the sectorial distribution, as depicted in Figure 3.15, the most *sukuk* issued were in the financial services and real estate sectors. However, the Government bodies are more active in the GCC markets as opposed to the sluggish attitude of the financial authorities in the Saudi Arabian market (Zawya, 2015).

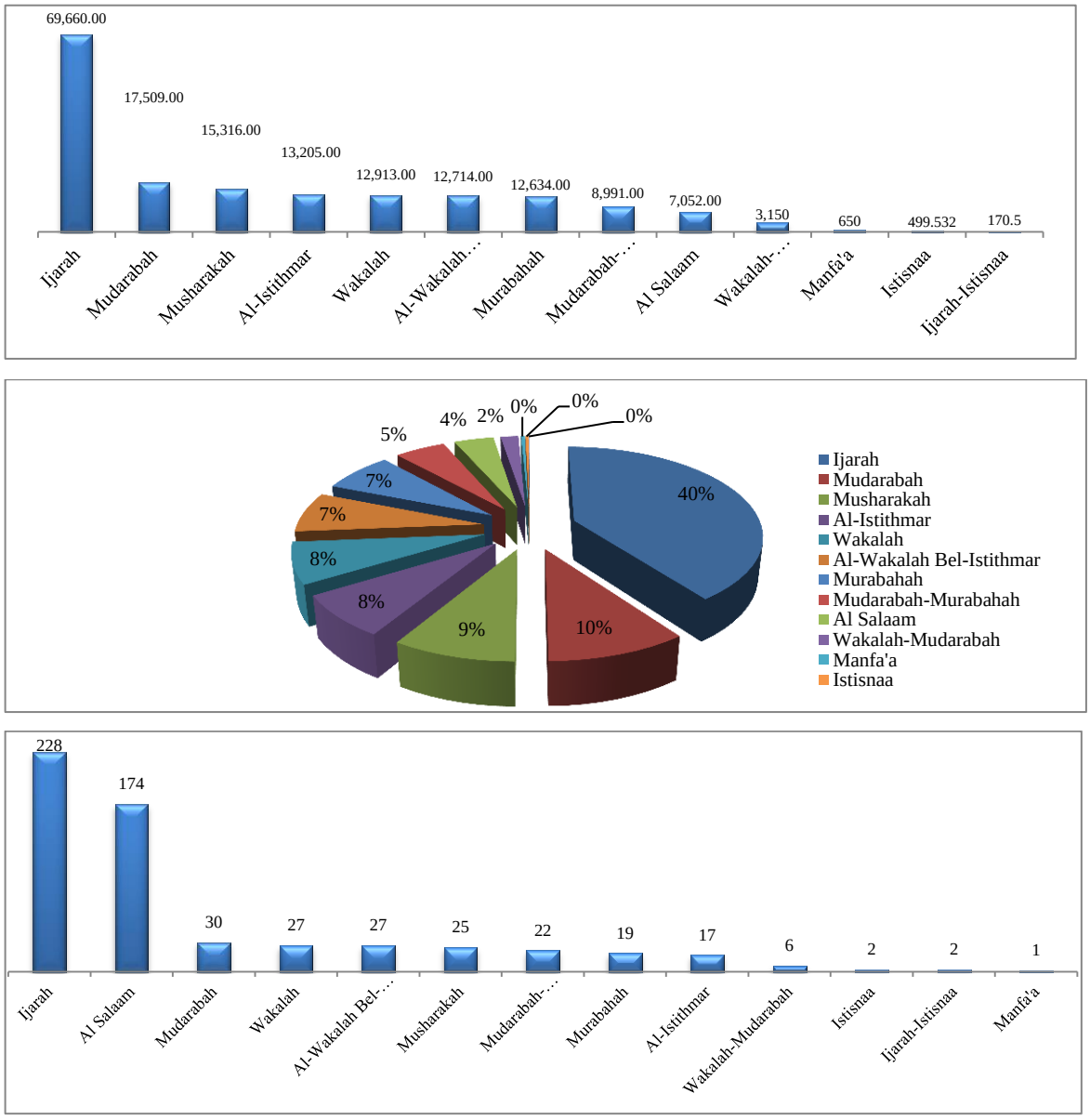
Figure 3.15: GCC *Sukuk* by Type of Issuance, Size and Number, 2003-2015, ($M)



Data Source: Zawya Database (2015)

As regards to the most frequently used *sukuk* structures at the GCC level, as depicted in Figure 3.16 (with three panels), *ijarah* structure is the most popular structure among the issuers with the total value of USD 69,660 million representing 40% of all the issuances in the GCC compared to other structures. This is followed by *mudarabah* and *musharakah* structures with total value of USD 17,509 million and USD 15,316 million respectively. However, *sukuk el-istithmar* can be the second most popular structure as the *sukuk el-istithmar* and *sukuk alwakalah bel-istithmar* can be the same structure with different name, as it has been stated by Latham and Watkins (2015).

Figure 3.16: GCC *Sukuk* by Type of Structure, Size and Number, 2003-2015, ($M)



Data Source: Zawya Database (2015)

As the discussion indicates, there are quite strong potential for the development of sukuk market in the GCC countries; while the decline in oil revenues can be considered as an adverse development, the financial engineering and financial ingenuity can contribute to the expansion of the *sukuk* market for the years to come.

3.3.3 LEGAL AND REGULATIVE ENVIRONMENT FOR ISLAMIC FINANCE AND *SUKUK* IN SAUDI FINANCIAL MARKET

The preceding section presented the dynamics of *sukuk* market in the GCC region with a particular focus on the Saudi Arabian market. The development of capital markets such as *sukuk* market, however, requires facilitatory regulative and legal environment. This section, hence, aims to discuss legal and regulative environment for the Islamic financial development in Saudi Arabia.

It should be noted in the beginning that the law of Saudi Arabia is *Shari'ah* -based inspired by *Quran* and the tradition of the Prophet Muhammad as the main source of legislation (Hanson, 1987). However, as far as the financial matters are concerned, Saudi Arabia stops short of a fully established Islamic financial sector, as the state seems to be not keen to promote the principles of the Islamic banking system (Wilson, 2007). In this regard, the Saudi government would appear to be hesitant to use the 'Islamic' label in relation to the banking system lest any failure could tarnish the image of the Islamic financial institutions across the world (Warde, 2000). However, the point is that the government of Saudi Arabia may attempt to set the balance right between Islamic and non-Islamic institutions so that labelling of some institutions as being Islamic will by definition exclude the rest as being non-Islamic, which will cause a state of confusion in the financial system (Warde, 2000).

Recalling that backed by the Saudi government, the OIC established the IDB in 1974 with the purpose of providing financial assistance to promote the process of economic and social development in the Muslim world in general and the member states in particular in accordance with the principles of *Shari'ah* (Chapra, 1996). Therefore, to reach that end Article 2 of the Royal Decree highlights the prohibition of interest-based transactions, where banks are involved in response to the principles of *Shari'ah*. However, such legal positioning contradicts the traditional approach featuring conventional banking where trading and financing processes are based on fixed interest rates.

3.3.4 Main Legal Bodies in the Saudi Financial Market

The management and supervision of the activities of the financial sector in Saudi Arabia are organized by two regulatory bodies (Alsmamrani, 2014). The first one is the Saudi Arabian Monetary Agency (SAMA) which was established in 1952 to undertake the function of the central bank including issuing the national currency, the Saudi Riyal, supervising commercial banks, managing foreign exchange reserves, promoting price and exchange rate stability, and ensuring the growth and soundness of the financial system, operating a number of cross-bank electronic financial systems such as *Tadawul*. The second institution is the CMA which was established under the 'Capital Market Law (CML)', promulgated by Royal Decree No. (M/30) dated 31/7/2003, to assume the supervisory and regulatory role over the parties falling under its authority (SAMA Web, 2015). The CMA is a government entity that enjoys financial and administrative autonomy and reports directly to the Head of the Council of Ministers. The Authority is vested with the regulation and development of the Saudi capital market and issuance of regulations, rules and instructions essential to applying the provisions of the CML.

CML defines CMA's main functions, the most important of which are to (CMA Webpage):

(i) "Regulate and develop the capital market, and seek to develop and improve the practices of entities trading in securities;
(ii) Protect investors in securities from unfair and unsound practices, or acts involving fraud, deception, cheating, manipulation or insider trading;
(iii) Seek to achieve fairness, efficiency and transparency in securities transactions;
(iv) Develop control mechanisms that mitigate the risks associated with securities transactions;
(v) Regulate and monitor the issuance of and trading in securities;
(vi) Regulate and monitor business activities of parties subject to the CMA's supervision;
(vii) Regulate and monitor the full disclosure of information pertaining to securities and their issuers, the dealings of informed persons and investors, and specify and provide the information that should be disclosed by participants in the market to shareholders and the public".

However, neither of the two bodies has retained powers as to provide *Shari'ah*-related supervision, as their duty has been focused on improving performance according to their law and regulations. Unlike countries such as Bahrain and Malaysia, the *Shari'ah* Supervisory Board or SSB's in Saudi Arabia have no specific rules for regulating the Islamic financial services. Instead, financial institutions are given a broad margin of freedom to choose their *Shari'ah*-compliant products assisted by their supervisory boards acting on the advice of *Shari'ah* scholars who constitute part of the membership of those boards.

In this regard, the main players are the *Shari'ah* scholars who have a duty to review the new products especially *sukuk* and services for *Shari'ah* compliancy (Bhambra, 2007). Thus, more efforts need to be made to improve employment standards for those scholars for better performance.

The current disagreement among scholars can result in confusion and misinformation. To avoid such implications highly qualified *Shari'ah* scholars need to be employed who must be knowledgeable in the area of finance and other related subjects including accounting and economics especially in Saudi Islamic finance market particularly *sukuk* market which has not been regulated yet (Alkhamees, 2013). The issues related to the SSBs are discussed in details in Chapter 5.

3.3.5 The Working of Islamic Finance in Saudi Arabia

Article 7 of the Constitution of Saudi Arabia provides that the government of Saudi Arabia drives power from the Holy *Quran* and the Prophet Muhammad's tradition (The Basic Law of Governance, 1992). That should mean that every aspect of the state governance including the banking and other finance activities should be consistent with *Shari'ah* principles. Accordingly, the Islamic label as it has been mentioned above should be a travesty in making no difference. In addition, Article 2 of the Royal Decree prevents SAMA from becoming involved in interest-based transactions so that the Islamic label has nothing to do with the nature of the bank's activities. In practice that should give more room for deviation from both the regular constitution and the Royal Decree so that conventional and Islamic financial institutions can operate side by side. However, neither the Royal Decree nor SAMA have made any reference to the Islamic character, and yet as indicated by SAMA webpage there is an increasing demand for *Shari'ah*-compliant banking products and

services in Saudi Arabia where all banks have become involved in *Shari'ah*-compliant business practice that entire operations to some extent are being conducted in an Islamic manner. According to SAMA regulation, similar to traditional banking; Islamic banking should be subject to the same control measures; and hence, it does not recognise exceptionalism for Islamic finance. Therefore, both Islamic and traditional finance are subject to the same rules.

In reflecting, the difficulties experienced by *Alrajihi* Bank to be libelled as 'Islamic Bank' should indicate the attitude of SAMA towards Islamic banks. *Alrajihi* is the largest institution for foreign exchange and remittance transfer in the country. However, the application of *Alrajihi* to transform the label into an Islamic bank was rejected by SAMA in 1989 on the grounds that such a move could by definition define other financial institutions as being non-Islamic. For that reason *Alrajihi* was given the license on condition that it would not be labelled as an Islamic institution (Wilson, 2007).

It should be noted that most traditional judicial affairs in Saudi Arabia are a matter for *Shari'ah* courts besides a number of quasi-judicial committees depending on the nature of the case involved (Hasan, 2009). It could be argued that the committees become important in cases that fall beyond the authority of *Shari'ah* courts (Wilson, 2007). Those committees include the commercial Papers Committee, the Banking Disputes Settlement Committee (BDSC), the Committee for the Resolution of Securities Disputes (CRSD) featuring the Saudi Capital Authority (McMillen, 2001; Wilson, 2008). In this regard, Chapter 7 will discuss in details the important issues related to legal authorities controlling the Islamic financial activities in Saudi Arabian market by particularly focusing on *sukuk* market.

3.3.6 *Shari'ah* Courts with Islamic Finance Cases

The fact that *riba* is strictly prohibited by *Shari'ah* law has an impact on court's decision regarding disputes in relation to cases involving banks and companies dealing in interest-based transactions. Therefore, the judges to be appointed to *Shari'ah* courts should always focus on *Shari'ah* compliancy. Accordingly, any claims to be made against clients who are in debt to banks that deal in interest-based transactions will be invalid according to *Shari'ah* law.

For example, Resolution No 291 of the Supreme Judicial Council rules out *Shari'ah* tribunals to become involved in mortgage disputes featuring loans given by commercial banks. That resolution mainly excludes *Shari'ah* courts from becoming involved in any interest-related bank disputes. Nonetheless, banks are still hopeful on the ground that the resolution will be reversed based on the argument that refusal to consider such disputes will pose a major risk to banks and clients. A case in point is the refusal of the Commercial Circuit at the Board of Grievances in 1996 to rule in a case involving bank shares where the contractual obligations between the defendant and the plaintiff involved is *ribawi* (Aljarbou, 2004). The *Shari'ah* courts are still adamant in not becoming involved in cases featuring interest-based transactions, as that would be a sinful practice in violation of the Islamic principles.

Given the increasing need for a body to settle disputes between banks and their clients, the Banking Disputes Settlement Committee (BDSC) has been established by SAMA *(*Al Homoud, *2011)*. In the same context, Committee for the Resolution of Securities Disputes (CRSD) was established in 2004 (Gouda, 2012).

The BDSC deals with disputes featuring the provisions of the CML by implementing the rules and regulations involving public and private matters. Nonetheless, in Saudi Arabia, interest is frequently referred to by different labels such as special commission income, service charges or book keeping fees (Wilson, 1991). Initially, BDSC was established by the Royal Order 729/8 of 1987 as an entity for resolving legal disputes in relation to banking. However, since its establishment, the BDSC as a legal entity, has managed by one way or another to avoid legal issues involving interest in relation to Islamic law, as from the technical point of view BDSC is not considered as judicial body, and so cannot be compared to the *Shari'ah* courts in terms of powers and privileges. Thus, the main purpose of the BDSC is to settle disputes between banks and their clients (Arafah, 2009). According to the regulation of BDSC's, which consists of three-member committee, main mission is mediating between the parties involved in the dispute, and that its decisions are not binding to either of the parties involved. In other words, by taking into account the circumstances of the disputing parties and the local traditions, the committee should be able to negotiate a settlement to resolve disputes otherwise it should refer the case to a competent tribunal in accordance with the Royal Decision ordering the

establishment of the committee. However, the committee should endeavour to enforce its decision through executive authority with no right of appeal in case the decision is unsatisfactory to one or both parties. It should be noted that from a legal perspective, a legal arrangement governing banking operations does not exist so far in the country and that the general law is the only reference for the committee to settle disputes featuring banking matters (Alghadyan, 1998). However, the rulings involving BDSC are subject to be backed and enforced by the appropriate government authorities provided the Civil Rights Directorate is being initially informed to follow up the enforcement procedures.

In this regard, Articles 3 and 4 of the Royal Decree Order of 728/8 of year 1987 would secure the power of enforcement of the procedures to be determined by BDSC for the settlement of potential disputes. Those powers include the right for the committee to seize or otherwise freeze the debtor's assets or to label the defendants as black listed as a measure to prevent from travelling abroad or from doing business with other banks (Tuck, 1991). Furthermore, the committee has the right to ban the debtor from doing business with government agencies and banks in case if he fails to cooperate with the committee in its efforts to reach a final settlement for the dispute (Tuck, 1991).

The authority of the BDSC is confined to cases involving disputes featuring banking activities as stipulated by Article One (b) of the banking control law. Thus, in cases of non-banking activities that banks are involved, the authority refers to the law courts and other legal tribunals. However, in theory, SAMA committee should resolve banking disputes according to *Shari'ah* standards. However, in practice, the committee has an obligation to force debtors to honour the terms of the agreements no matter that agreement involves interest-based transactions or not. The only important condition is that the transaction should be consistent with the law of Saudi Arabia. In other words, the committee should spare no efforts to make the parties involved respect their agreements even though those agreements are not *Shari'ah* compliant (McMillen, 2000).

3.3.7 Legal Environment for *Sukuk* in Saudi Arabia

Until today, the *sukuk* marketplace especially in Saudi market needs to be developed in terms of regulatory conditions (Ali, 2011). In many Muslim countries, principles

featuring standardisation and regulation of *sukuk* have been issued so as to enhance the confidence of both investors and issuers in the market (Alexakis and Tsikouras, 2009). However, there is still more work to be done across the world in general and in Saudi Arabia particularly to secure a sustainable growth and stability of *sukuk* market.

It should be noted that by CMA and under the Securities Regulations code; no reference has been made to *sukuk* as *Shari'ah* compliant product. In fact, the rules tend to focus on the procedures rather the substance with regard to *sukuk* issuance (Capital Market Authority, Offers of Securities Regulations, dated 04/10/2004 amended 28/01/2008).

As mentioned above, a suitable environment conducive to *sukuk* has yet to be created by regulators in Saudi Arabia. In this regard, particular attention should be given to the resolution of disputes, whereby a clear mechanism for resolving disputes should favour investors who would otherwise remain hesitant to become engaged in any vague deals involving *sukuk* (Al Elsheikh and Tanega, 2011). In countries where *sukuk* legislation is more advanced usually jurisdiction is a matter for the relevant regulator of securities. However, as far as Saudi Arabia is concerned, jurisdiction over *sukuk* is indefinite, whereby many organisations become involved in the matter including *Shari'ah* Courts, the Grievances Court, SAMA, and the CMA. This results in a state of confusion and uncertainty for both investors and issuers of *sukuk* by making *sukuk* deals less attractive to businessmen and investors in Saudi Arabia.

From the this discussion it becomes obvious that a clearly defined and standardised regulatory system for *sukuk* market needs to be established in Saudi Arabia as to facilitate Islamic financial expansion in general and *sukuk* market in particular, which can create an efficient and competitive environment for promotion of *sukuk* as a source for financing government and corporations. Thus, issues relating to regulative and legal environment are discussed in detail in Chapter 7.

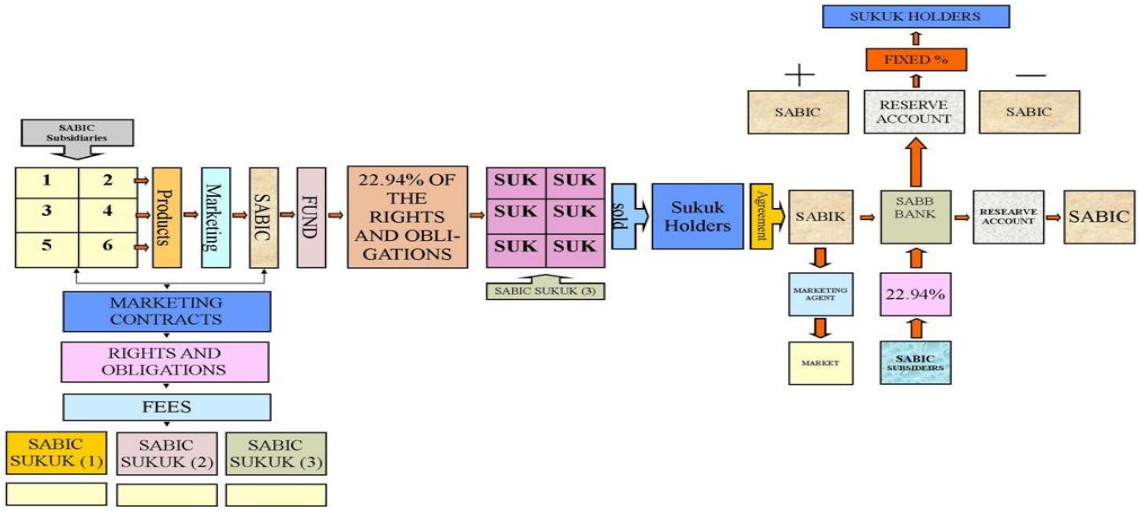
3.4 AN INTRODUCTION TO SABIC *SUKUK*

This section focuses on rendering an introduction to SABIC *sukuk* with the objective of providing an appropriate context.

3.4.1 The Description of the Structural Steps of SABIC *Sukuk*

Figure 3.17 is developed by examining and deconstructing the mechanism of the SABIC *sukuk* from initial step to the distribution of returns, which hence depicts the entire structure and process of SABIC *sukuk.*

Figure 3.17: The Description of the Structural Steps of SABIC *Sukuk*



After a close examination of the issuance prospectus, the issuance structure, as depicted in Figure 6.1 can be summarised through the following points:

(i) The SABIC *sukuk* represents 22.94% of the rights and obligations featuring the marketing agreements between SABIC and the subsidiary companies for 20 years. However, after 20 years or otherwise in any case, when the *sukuk* expires, even before the 20 years, then the SABIC will be the sole claimant of all the rights and obligations as referred to by the marketing agreements. 22.94% of the rights and obligations, as defined by the marketing agreement between the issuer (SABIC) and the subsidiary companies, have been transformed by the former to *sukuk* before being put forward for subscription by the public.

(ii) All investors have subscribed to this issuance, and accordingly have paid the par value of *sukuk* to the issuer in cash, *i.e.* SR 10,000 per one of the *sukuk* – for owning one of the *sukuk* representing a common share in 22.49 % of the rights and obligations as defined by a 20-year marketing agreement signed between the issuer and the

subsidiary companies. In other words, *sukuk* holders will receive 22.49% of the total bonuses and fees, which will be generated from marketing the products of SABIC subsidiaries. However, it should be noted that in theory in order to become eligible for the marketing fees featuring the returns from *sukuk*, the *sukuk* holders have a duty to undertake the marketing process in relation to the selling of the products of SABIC subsidiary companies.

(iii) Prescribing in *sukuk* implies that the investor (*sukuk* holder) should as a condition to designate SABB Bank (Saudi Arabia) as a commission agent to represent him in all matters pertaining to *sukuk*. Accordingly, the bank will be labelled as 'the agent of *sukuk* holders' and in return the bank will be eligible for a total annual payment of SR 750,000.

(iv) The contract between the agent of *sukuk* holders (SAAB Bank) and SABIC is described as a hire contract for doing a job, whereby the hirer is *sukuk* holders and SABIC is the worker. Accordingly, SABIC should be committed to undertake the marketing and selling of the products of the subsidiary companies on behalf of *sukuk* holders, in return for a payment of 1% of the total returns of the marketing the products to which the *sukuk* holders are entitled. That agreement is known as 'the agreement for the management of *sukuk* assets'.

(v) According to the 'agreement for the management of *sukuk* holders', one of the duties of the 'manager of *sukuk* assets' – SABIC – is the collection of money pertaining to *sukuk* holders, *i.e*. the collection of 22.49% of marketing fees to be paid by SABIC subsidiary companies to *sukuk* holders. The money will be paid into a virtual account in the name of *sukuk* holders labelled as 'reserve account' for the sake of SABIC accounts records, rather than an independent bank account for *sukuk* holders.

It is also, worth mentioning that the 'manager of *sukuk* assets' – SABIC – has set a condition for *sukuk* holders by preserving the right of using any funds in the reserve account featuring the virtual account in excess of the sums due to be distributed among *sukuk* holders on the defined dates. In this case, SABIC is considered as a borrower of the excess money, so that SABIC will become the sole claimant of any profits made by investing those sums.

It is also, imperative to highlight the fact that according to the prospectus of issuance, the quarter-yearly periodic profits as well as the additional sums (10%) to be distributed to *sukuk* holders every five years. This should be covered by the money belonging to *sukuk* holders in the reserve account. However, in case of expiry of *sukuk* (either by being purchased by the issuer in response to a request from *sukuk* holders after five years have passed, in case of failure, or otherwise at the end of the 20 years when the *sukuk* expire), in case some funds remain in the reserve account after the expiry of *sukuk*, no matter the amount remaining in excess of funds that have been distributed as shown above, SABIC has set a condition to take those sums as an incentive for its good management of *sukuk* assets.

In case, sufficient amounts of money are available in the virtual account of *sukuk* holders 'the reserve account', then the amount available will cover the periodic profits. However, in case the amount is insufficient to cover the full amount agreed upon, *i.e.* SIBOR + 48 basing (0.48%) points, then the amount available will be distributed proportionally among *sukuk* holders, and the remaining unpaid sums will be considered as deficit to be paid later should the money available in the virtual account (the reserve) allow that payment. In other words, the issuer, *i.e*. SABIC, will not pay anything of the quarter-yearly profits from its own funds, but rather pay from whatever is available for *sukuk* holders from the rights featuring the fees collected from marketing the products of the contracting subsidiary companies of SABIC.

(vi) On the dates of the distribution of quarter-yearly periodic profits, the manager of the assets of *sukuk* will distribute the profits among *sukuk* holders after allowing for discounts featuring the management fees and other costs. The profits will be calculated according to the interest rates, *i.e.* the rates of deposits in Saudi Riyals for three months – (SIBOR) + 48 basing points (0.48%) of the par value of *sukuk* valid until that date, at the expense of the virtual account belonging to *sukuk* holders referred as 'the reserve' in Article 5 shown above.

(vii) An additional profit known as 'additional amount' at the rate of 10 % of the total par value of *sukuk*, valid until that date, will be distributed among *sukuk* holders by the 'manager of *sukuk* assets' at the expense of the virtual account belonging to *sukuk* holders referred as 'the reserve' in Article 5 shown above.

(viii) The issuer, *i.e.* SABIC, commits itself by giving an irreversible promise that they will purchase all or some of the *sukuk* at the end of every five-year period with at the request of *sukuk* holders.

The issuer has promised to purchase the *sukuk* from *sukuk* holders as following price:

(a) 90 % of the par value of *sukuk* at the end of the year five.

(b) 60 % of the par value of *sukuk* at the end of year ten.

(c) 30 % of the par value of *sukuk* at the end of year fifteen.

At the end of year 20, the *sukuk* will eventually expire and the value will be zero.

(ix) The issuer, *i.e.* SABIC has made a commitment by giving an irreversible promise to purchase all or some of the *sukuk* with at the request of *sukuk* holders in the event of emergency or what is known as 'cases of failure' such as:

(a) Failure of SABIC to pay the periodic quarter-yearly profits or otherwise in cases of deficits in profits to be distributed among *sukuk* holders as to become less than the amount agreed upon – SIBOR+ 48 basing points – or in case of failure of SABIC to pay the 'additional amount' to be distributed every five years or deficits in the distributed amount as to become less than the amount agreed upon, *i.e.* 10%, provided that failure is directly linked to the negligence of the manager of *sukuk* assets – SABIC – to his duties or his failure to live up to his commitments as provided by the provisions of 'the management of *sukuk* assets agreement'.

(b) Failure of the issuer, namely SABIC, to meet deadlines with regard to paying its debts to donors, whoever those donors are, provided that the unpaid debts should not exceed SR 175 million or an equivalent of that amount in foreign currency.

(c) Insolvency of the issuer or otherwise the dissolution of the issuer by a court order.

It should be noted that many details could be found in the issuance prospectus regarding the method of purchase, and the price to be paid by SABIC to *sukuk* holders

at the time of failure. Nonetheless, the most important point is that, *sukuk* holders should be paid their *sukuk* value in full, *i.e.* 100 %, on top of any periodic quarter-yearly profits due in case of failure in the first five years, in response to a request of *sukuk* holders from SABIC to buy their *sukuk*.

From the forgoing the issuance structure can be summarised in the following points:

(i) The investor has to pay SR 10,000 to SABIC to obtain one of the *sukuk* on offer for investment. That sum represents a specific percentage of the rights and commitments of SABIC featuring in 14 of the marketing agreements between SABIC and its subsidiary companies in Saudi Arabia.

(ii) SABIC has been chosen by *sukuk* holders as to represent them in the marketing and selling of the products of the subsidiary companies. In return, SABIC will be eligible for 1 % of the profits of the marketing contracts which have become the sole right of *sukuk* holders.

(iii) SABIC has to collect the fees after making a discount of 1% to go to a virtual account as a reserve in the name of *sukuk* holders, so that SABIC should pay *sukuk* profits every three month from that account. That profit represents the index of interest rate for Saudi banks in three month, *i.e.* SIBOR + 48 basing points – 0.48 %.

(iv) From its part SABIC is committed to purchasing the *sukuk* from investors upon request – after five years the price will be 90 % of the par value of *sukuk, i.e.* SR 9,000 per one *suk*. In the meantime, SABIC has to pay *sukuk* holders from the reserve account an equivalent of 10% of *sukuk* value or what is known as the 'additional amount'. Through that arrangement, the *sukuk* holder will be paid back his due debts in full, *i.e.* 100% of the par value of *sukuk* at the end of the first five years period on top of the quarter-yearly profits that has already been paid during the five years.

(v) In addition to the above arrangement, the *sukuk* will be secured from any potential risks before the expiry date is due. In this regard, SABIC is fully committed to buying the *sukuk*, and that commitment is irreversible, so that the *sukuk* holders will be able to get 100% of the par value of *sukuk* by the end of the first five years before the *sukuk* expire in 20 years' time as provided by the issuance prospectus.

3.5 CONCLUSION

The Saudi *sukuk* market is still considered the second largest market after the Malaysian market despite the sharp fall in the *sukuk* issuances in the past two years. While the contraction is attributed to the dramatic decline in the oil prices, such a financial shortage be a benefit in disguise as government may opt for *sukuk* to overcome the observed contraction in the revenues. For example, the government of Saudi Arabia announced recently that there is a deficit in its budget for 2016. This shortage, as it has been stated by the Minister of Finance, could be financed by issuing *sukuk* in particular for public sector long term project financing. Since government seems to be considering such an option, there might be expansion in the Saudi Arabian *sukuk* market.

Regardless of the positive developments in the *sukuk* market, there are number of other challenges which include *Shari'ah* and legal criticisms by creating *Shari'ah* and legal risks. These risks are related to the structures applied in the Saudi *sukuk* market or related to the jurisdictions that approve these structures. However, beyond such risks, considering the potential of *sukuk*, SAMA and CMA should promote the financial sector by improving the regulatory procedures in relation to the international and domestic operations for *sukuk.*

Table 3.3: The Number of *Sukuk* Issued by Issuer, Issue Date, Type of *Sukuk*, Currency, Maturity Between 2003 and 2015 in Saudi Arabia

No	Date	Issuer	Currency	Type of Issued *Sukuk*	Listed-Not	Amount (US$m)
1.	18-12-2015	Al Bayan *Sukuk* (IMTN 3)	MYR	*Wakalah*	Not Listed	23.326
2.	19-10-2015	APICORP *Sukuk*(Tranche 1)	USD	*Wakalah*	Not Listed	500
3.	08-10-2015	Islamic Development Bank MTN *Sukuk* (Series 24)	EUR	*Al-Wakalah Bel-Istithmar*	Not Listed	340.68
4.	08-09-2015	Arab National Bank Callable *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	533.333
5.	26-08-2015	*Almarai* Senior *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	426.849
6.	09-09-2015	Islamic Development Bank MTN *Sukuk* (Series 23)	EUR	*Al-Wakalah Bel-Istithmar*	Not Listed	112.68
7.	31-08-2015	*Al Othaim* Real Estate and Investment Company *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	266.667
8.	28-07-2015	*Bahri Sukuk*	SAR	*Mudarabah-Murabahah*	Listed	1,039.97
9.	15-07-2015	NCB Tier I Perpetual *Sukuk*	SAR	*Mudarabah*	Not Listed	533.291
10.	09-07-2015	Islamic Development Bank MTN *Sukuk* (Series 22)	EUR	*Al-Wakalah Bel-Istithmar*	Not Listed	109.65
11.	25-06-2015	Saudi *Binladin Sukuk*	SAR	*Murabahah*	Not Listed	266.667
12.	24-06-2015	Riyadh Bank *Sukuk* II	SAR	*Al-Istithmar*	Not Listed	1,066.67
13.	22-06-2015	NCB Subordinated Tier I *Sukuk*	SAR	*Mudarabah*	Not Listed	266.667
14.	10-05-2015	*Najran* Cement *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	106.661
15.	28-05-2015	SABB Tier 2 Sukuk 2025	SAR	*Mudarabah-Murabahah*	Not Listed	399.989
16.	01-05-2015	Islamic Development Bank MTN *Sukuk* (Series 21)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	1,000
17.	17-11-2014	Advanced Petrochemical *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	266.539
18.	31-10-2014	Islamic Development Bank MTN *Sukuk*(Series 20)	EUR	*Al-Wakalah Bel-Istithmar*	Not Listed	375.72
19.	18-09-2014	Islamic Development Bank MTN *Sukuk*(Series 19)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	1,500
20.	17-06-2014	Islamic Development Bank MTN *Sukuk*(Series 18)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	1,000
21.	26-06-2014	*Alhokair Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	133.319
22.	23-06-2014	National Petrochemical Company (Petrochem) Sukuk	SAR	*Al-Istithmar*	Not Listed	319.94
23.	18-06-2014	Banque Saudi Fransi Tier 2 *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	533.234
24.	10-06-2014	Saudi Telecom *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	533.262
25.	5-06-2014	Saudi Investment Bank *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	533.248
26.	20-05-2014	*DAAR Al-Arkan Sukuk* V(Tranche 3)	USD	*Wakalah*	Not Listed	400
27.	1-04-2014	Saudi Electricity Global *Sukuk* III(Tranche 1)	USD	*Ijarah*	Not Listed	1,500
28.	1-04-2014	Saudi Electricity Global *Sukuk* III(Tranche 2)	USD	*Ijarah*	Not Listed	1,000
29.	9-03-2014	Islamic Development Bank MTN *Sukuk*(Series 16)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	1,500
30.	19-02-2014	NCB Subordinated Tier II *Sukuk*	SAR	*Mudarabah*	Not Listed	1,333.23
31.	30-01-2014	Saudi Electricity Company *Sukuk* IV	SAR	*Al-Istithmar*	Listed	1,199.90
32.	17-12-2013	SABB Tier 2 *Sukuk* 2020	SAR	*Mudarabah-Murabahah*	Not Listed	399.979
33.	15-12-2013	Saudi Hollandi Bank Tier 2 Sukuk	SAR	*Mudarabah-Murabahah*	Not Listed	666.631
34.	20-11-2013	*DAAR Al-Arkan Sukuk* V(Tranche 2)	USD	*Wakalah*	Not Listed	300
35.	11-11-2013	Riyadh Bank *Sukuk*	SAR	*Al-Istithmar*	Not Listed	1,066.58
36.	08-11-2013	*Al Bayan Sukuk*(IMTN 2)	MYR	*Wakalah*	Not Listed	37.766
37.	24-09-2013	General Authority of Civil Aviation	SAR	*Murabahah*	Listed	4,055.94
38.	25-09-2013	*Almarai* Perpetual Senior *Sukuk*	SAR	*Mudarabah-Murabahah*	Not Listed	453.297
39.	10-06-2013	Saudi *Binladin* Short Term *Sukuk* IV	SAR	*Murabahah*	Not Listed	266.645
40.	04-06-2013	Islamic Development Bank MTN *Sukuk*(Series 15)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	1,000
41.	22-05-2013	*DAAR Al-Arkan Sukuk* V(Tranche 1)	USD	*Wakalah*	Not Listed	450
42.	21-05-2013	*Marafiq Sukuk*	SAR	*Al-Istithmar*	Not Listed	666.578
43.	24-04-2013	*Al Bayan Sukuk*(IMTN 1)	MYR	*Wakalah*	Not Listed	65,595
44.	08-04-2013	Saudi Electricity Global *Sukuk* II(Tranche 1)	USD	*Ijarah*	Not Listed	1,000
45.	08-04-2013	Saudi Electricity Global *Sukuk* II(Tranche 2)	USD	*Ijarah*	Not Listed	1,000
46.	16-03-2013	Sadara (Aramco) *Sukuk*	SAR	*Musharakah*	Listed	1,999.89
47.	30-03-2013	*Almarai Sukuk*(Tranche 2)	SAR	*Mudarabah-Murabahah*	Not Listed	209.85
48.	30-03-2013	Almarai *Sukuk*(Tranche 3)	SAR	*Mudarabah-Murabahah*	Not Listed	136.789
49.	27-03-2013	Saudi Binladin *Sukuk* IV	SAR	*Ijarah*	Not Listed	346.648
50.	27-03-2013	Islamic Development Bank MTN *Sukuk*(Series 14)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	700
51.	17-03-2013	*Bahri* (formerly- National Shipping Company)	SAR	*Not known*	Not Listed	1,300.00
52.	22/01/2013	Savola Group	SAR	*Not known*	Not Listed	399.92
53.	01/01/2013	Sadara Chemical Company (SADARA)	SAR	*Not known*	Not Listed	1400
54.	08-01-2013	Orix *Sukuk* 2015	SAR	*Al-Istithmar*	Listed	63.985
55.	18/12/2012	Banque Saudi Fransi - BSF	SAR	*Mudarabah-Murabahah*	Not Listed	506.56
56.	20/11/2012	Saudi Hollandi Bank	SAR	*Mudarabah-Murabahah*	Listed	373.284

57.	11/10/2012	Islamic Development Bank MTN *Sukuk*(Series 13)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	500
58.	10/10/2012	*Al Marai* Company	SAR	*Not known*	Not Listed	346.61
59.	01-10-2012	Islamic Development Bank MTN *Sukuk*(Series 12)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	300
60.	07-08-2012	Islamic Development Bank MTN *Sukuk*(Series 11)	GBP	*Al-Wakalah Bel-Istithmar*	Not Listed	156.177
61.	31-07-2012	Saudi *Binladin* Short Term *Sukuk* III	SAR	*Murabahah*	Not Listed	266.645
62.	01/07/2012	ACWA Power International	USD	*Murabahah*	Not Listed	300
63.	27/06/2012	*Olayan* Group	SAR	*Investment Sukuk*	Not Listed	173.3
64.	10-06-2012	Islamic Development Bank MTN *Sukuk*(Series 10)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	800
65.	21/05/2012	National Industrialisation Company (Tasnee)	SAR	*Mudarabah Murabahah*	Not Listed	533.24
66.	15-05-2012	Saudi Fransi	SAR	*Wakalah*		750
67.	14-04-2012	AJIL *Sukuk*	SAR	*Al-Istithmar*	Not Listed	133.323
68.	28/03/2012	Saudi Electricity Global Sukuk(Tranche 2)	USD	*Ijarah*	Not Listed	1,250
69.	28/3/2012	SABB	SAR	*Mudarabah Murabahah*	Not Listed	400
70.	07/03/2012	*Al Marai* Company	SAR	*Mudarabah Murabahah*	Not Listed	266.6
71.	30-01-2012	Islamic Development Bank MTN *Sukuk*(Series 9)	GBP	*Al-Wakala Bel-Istithmar*	Not Listed	157.085
72.	18/01/2012	General Authority Of Civil Aviation (GACA)	SAR	*Murabahah*	Not Listed	4000
73.	12/09/2011	Arabian Aramco Total Services Company (AATSC) SATORP *Sukuk*	SAR	*Musharakah*	Listed	1000
74.	16-07-2011	Saudi Binladin Short Term *Sukuk* III	SAR	*Murabahah*	Not Listed	266.652
75.	14/06/2011	Saudi International Petrochemical Company (Sipchem)	SAR	*Mudarabah*	Listed	480
76.	12-05-2011	Islamic Development Bank MTN *Sukuk*(Series 8)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	750
77.	29/03/2011	Bank *Al Jazirah*	SAR	*Mudarabah Murabahah*	Not Listed	267
78.	17-02-2011	Islamic Development Bank MTN *Sukuk*(Series 7)	GBP	*Al-Wakalah Bel-Istithmar*	Not Listed	97.04
79.	27-10-2010	Islamic Development Bank MTN *Sukuk*(Series 6)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	500
80.	20-09-2010	Islamic Development Bank MTN *Sukuk*(Series 5)	SAR	*Al-Wakalah Bel-Istithmar*	Not Listed	249.993
81.	20-09-2010	Islamic Development Bank MTN *Sukuk*(Series 4)	SAR	*Al-Wakalah Bel-Istithmar*	Not Listed	249.993
82.	05/10/2010	Saudi Electricity Company	SAR	*Investment Sukuk*	Listed	1900
83.	12-07-2010	Saudi Binladin Short Term Sukuk	SAR	*Murabahah*	Not Listed	186.682
84.	02/07/2010	*Al Aqeeq* Real Estate Development Co.	SAR	*Not known*	Not Listed	186.66
85.	18-02-2010	*Dar Al-Arkan* International *Sukuk* Company II	USD	*Wakalah*	Not Listed	450
86.	13/12/2009	Saudi Hollandi Bank	SAR	*Mudarabah*	Listed	193.30
87.	16-09-2009	Islamic Development Bank MTN *Sukuk*(Series 2)	USD	*Al-Wakalah Bel-Istithmar*	Not Listed	850
88.	14-09-2009	Islamic Development Bank MTN *Sukuk*(Series 2)	SGD	*Al-Wakalah Bel-Istithmar*	Not Listed	140.479
89.	10/06/2009	Saudi Electricity Company	SAR	*Investment Sukuk*	Listed	1866.66
90.	05/15/2009	*Dar Al Arkan* Real Estate Development Company (Dar Al Arkan)	SAR	*Sukuk Al Ijarah-Murabahah*	Not Listed	200
91.	29/12/2008	Saudi Hollandi Bank	SAR	*Mudarabah*	Not Listed	206.457
92.	17/09/2008	Saudi *Binladin* Group	SAR	*Mudarabah*	Not Listed	267
93.	28/04/2008	Saudi Basic Industries Corporation (SABIC)	SAR	*Investment Sukuk*	Listed	1333.20
94.	03/16/2008	*Tajeer*	SAR	*Investment Sukuk*	Not Listed	66.84
95.	09-07-2007	*Dar Al-Arkan* International *Sukuk* Company	USD	*Ijarah*	Not Listed	1,000
96.	25-06-2007	Saudi Electricity Company	SAR	*Investment Sukuk-(Ijarah, Zawya)*	Listed	1,333.19
97.	08/06/2007	Saudi Basic Industries Corporation (SABIC)	SAR	*Investment Sukuk*	Listed	2100
98.	15-05-2007	Golden Belt 1 *Sukuk*	USD	*Manfa'a*	Not Listed	650
99.	7-03-2007	*DAAR Al-Arkan* International *Sukuk*	USD	*Ijarah*	Not Listed	600
100	18/07/2006	KSA MBS I International *Sukuk* Company Limited	USD	*Sukuk Al Ijarah Istisnaa*	Not Listed	18
101	03-07-2006	Saudi Basic Industries Corporation (SABIC)	SAR	*Investment Sukuk*	Listed	799.957
102	16-06-2005	Islamic Development Bank MTN *Sukuk*(Series 1)	USD	*Ijarah*	Not Listed	500
103	10/12/2004	*Munshaat* Real Estate Projects Company	USD	*Sukuk Al Ijarah*	Not Listed	390
104	05/08/2004	*Tajeer*	USD	*Sukuk Al Ijarah*	Not Listed	1.60
105	01-05-2004	CARAVAN I Limited	SAR	*Ijarah*	Not Listed	26.133
106	03-08-2003	Solidarity Trust Services Ltd *Sukuk*	USD	*Ijarah*	Not Listed	400

Source: IFIS database (2013); *Zawya* database (2015) and *Tadawul* database (2015)

Chapter 4

RESEARCH METHODOLOGY

4.1 INTRODUCTION

This chapter aims at discussing the research methodology issues related to the conduct of this research, which includes a detailed description of the research methods in terms of collecting and analysing the acquired data in an attempt to generate responses and answers for the identified research questions. As far as this research is concerned both qualitative and descriptive methods have been used given the fact that the main objective of the research is to investigate the risks involved in *sukuk* structures that have been issued in Saud Arabia through qualitative data.

This chapter is subdivided into six sections, as follows: after this introduction, the research methodology section is presented, which is followed by research design and research strategy sections. The chapter also presents the research methods and research limitations in fifth and sixth sections.

4.2 RESEARCH METHODOLOGY

Research methodology is defined as solving research problems in a systematic manner in a procedural and rational manner (Rajendra, 2008). According to Collis and Hussey (2013), the overall perspectives and procedures as well as other research activities including data acquisition and data analysis should constitute an important component of research methodology.

As Kerlinger (1973:703) puts it, research methodology could be referred to as "controlled investigation of theoretical and applied aspects of mathematical and statistical measurements, as well as ways of analysing and obtaining data". In this regard, in a functional manner, McNeill and Chapman (2005) argue that research methodology tends to enable the researcher to develop a clear research framework as to achieve the research goals and objectives. Thus, research methodology refers to the framework through which the research is articulated philosophically and theoretically to make it operational. The choice of particular research methodology nonetheless is always a function of the research aim and objectives.

The existing literature shows that research methodology can be qualitative or quantitative in its nature (Kumar, 2008). Q*uantitative research* implies principles featuring positivist philosophy as a guide, as according to some researchers an objective reality always exists as a separate entity from the observers' perceptions, and understanding that reality becomes the sole target of scientific research (Bryman, 2015). *Qualitative research* studies, on the other hand, tend to focus on words mainly social relations and describing realities as perceived by the appropriate respondents (Bryman, 2015). Thus, both qualitative and quantitative research implies a different way of thinking. In other words, quantitative research is related to 'examining' and 'evaluating' a particular fact or issue; while qualitative research method relates to 'explorations of opinions', 'perceptions' and 'behaviours' in a sense to locate how the participants are making sense of their realities. Therefore, qualitative research relates to social constructivism and interpretativism as an ontological base, while quantitative research remains within positive philosophical position in the sense of examining facts.

As far as this study is concerned, a qualitative methodology is deemed to be appropriate; as this study focuses on how social reality, namely risk relating to *sukuk* from *shari'ah* and legal perspective, is perceived by scholars, lawyers and banking/finance professionals. This research, therefore, is an explorative study, in the sense of exploring the opinion, evaluation, and perceptions of the participants on legal and *Shari'ah* risks aspects of SABIC *sukuk*, whereby it is located within the interpretative approach within social constructivism.

4.3 RESEARCH DESIGN

The research design constitutes an important aspect of research activities, where the research questions are to be properly organised to be put into perspective featuring a general plan to achieve the research aims, objectives and questions (Saunders *et al*., 2007; Bryman and Bell, 2015). The research design provides a framework that would enable the researcher to gather information and data in the desired area of investigation; thus, providing a structure for data collection and data analysis (Bryman, 2015). In fact, a well-structured research design will enable the researcher to organise the various parts of the research featuring methods of data collection and data analysis as well as linking them together (Stacey, 1969). Thus, failure to establish

a well organised research design should mean poor and unreliable research findings due to inability to answer the research questions as required (Vases, 2001).

Frankfort-Nachmias and Nachmias (1996), thus, refer to research design as a 'blueprint' of a specific study, where the research design becomes as an instrument to assist and monitor the researcher through the various phases of study. That should imply every research project is unique in terms of its research design featuring the use of appropriate tools and methods to reach the most accurate results and conclusions. This implies that the process of answering the research questions should become a function of the right research strategy, and the right research design that would lead to the achievement of the research objectives (Kumar, 2002). In other words, an appropriate methods needs to be used in order to provide an accurate description of the phenomenon under investigation.

The available literature indicates that research design can be classified as exploratory, descriptive and explanatory types of research (Kothari, 2004; Saunders *et al*., 2007), which are described as follows:

(i) Exploratory research is mainly associated with issues that have not been clearly identified (Sekaran, 2003), implying that the subject matter is new at least in a particular case and context. According to Stebbins (2001), exploratory research would manage to gather preliminary information to define problems and suggest hypothesis, which therefore relates to a particular issue requiring explorations. Due to such a nature, flexibility and adaptability to change constitute an important feature of exploratory research, so that a researcher can easily change his or her line of thought as result of new findings that appear along the way. However, Adams and Schvaneveldt (1991) suggested that the flexibility associated with exploratory research should not mean the loss of direction to the inquiry, but should rather mean a narrower focus as the research progresses.

(ii) Descriptive research where researchers use past incidents to explain existing observable facts in order to establish an accurate profile of persons, events or situations (Robson, 2002). Descriptive research necessitates a clear picture of the phenomenon under investigation prior to data collection, which also represents a

preceding phase to exploratory or explanatory research as to draw further conclusions and synthesise ideas from the description of data.

(iii) Explanatory research relates to studies featuring casual relationships as to explain the reasons behind the existence of specific phenomena (Saunders *et al*., 2007), and therefore is mainly utilised by quantitative methods in establishing relationships.

In addition to these three main research design areas, there are other research design types found in the literature:

(i) *Survey research* is commonly linked to studies related to business and management to answer questions featuring who, what, where, how much and how many. In other words, this strategy is most appropriate for exploratory and descriptive research. The main advantage of this approach is that it allows the collection of a large amount of data through questionnaires and interviews from a relatively small population at the minimum cost possible (Saunders *et al*., 2007).

(ii) *Grounded theory*, as a research design, aims to provide the best example of the inductive approach (Glaser and Strauss, 1967). Nonetheless, some believe that this approach is a product of a combination of inductive and deductive approaches. According to Goulding (2002), the grounded theory is useful for predicting and explaining behavioural matters. Moreover, in cases where grounded theory becomes important, data collection can be done without the need for a theoretical framework, whereby the theory can be developed from data observations. Then prediction could be made to be further tested to be confirmed or rejected by more observation along the way.

(iii) *Case study* is another design commonly used in social sciences. Eisenhardt (1989:534) points out that "case studies combine data collection methods such as archives, interviews, questionnaires and observations, and in addition they are used to accomplish various aims such as providing description, testing or generating theory". However, through case study, a researcher will be able to address a particular research question as to explore the subject matter via the participants' perceptions (Yin, 2003). In other words, strategies involving case studies tend to seek answers to questions as to explain the reasons behind events as to what happened, how it happened and why it

happened, making case studies the most appropriate for exploratory and explanatory research. In order to establish facts about specific subject that should establish an in-depth investigation in relation to the subject involved no matter that being an individual, an institution or even a community at large, investigation should be based on careful observation of the subject in question. The researchers have to focus on the facts related to the subject rather than seek their own hypothesis. However, given the flexibility and resilience of case study approach, it tends to leave the door wide open for researchers rather than restricting their views on the subject under investigation (Kumar, 2002).

Considering all the research designs presented, this research is constructed as an exploratory and survey based case study. It is exploratory, as it aims to explore the opinions of various *Shari'ah* scholars, Islamic finance experts, judges, lawyers, academic staff and people involved in CMA on the subject matter. In addition, this study is framed as a case study, as this study focuses on *sukuk* issued in Saudi Arabia, particularly SABIC *sukuk* referring to a particular *sukuk* issued by a company called SABIC. Since primary data for this research is collected through an interview schedule, this study should also be considered within survey design. It should also be noted that this research benefits from descriptive research through primarily based on library-collected information, such as textbook, journal articles, reports and *sukuk* brochures. The majority of these resources can be accessed via libraries as online material. Within this descriptive nature, this research utilises analytical critique as an interpretative research method to examine the existing *sukuk* structures and legislations offered to deal with *sukuk*.

4.3.1 Rationalising the Selection of Case Study

Since this research is a case study, the choice of SABIC *sukuk* as a case should be rationalised. Given that SABIC Company is one of the biggest companies in Saudi Arabia associated with petrochemicals, whose shares are also heavily traded in the Saudi stock market, *Tadawul*. Thus, the size and operational level of the company indicates its importance and hence rationalise its choice in this study. In addition, given the fact that SABIC has issued three *sukuk* in the Saudi market, the size of the issues have been rather large which again provides another rationale for choosing this particular corporation. Furthermore, among the reasons that have made the researcher

to choose SABIC *sukuk* as a case is the fact that the three members of *Shari'ah* board that has approved SABIC *sukuk* are considered among the most reputed scholars in Saudi Arabia in the area of Islamic finance in general and particularly in relation to *sukuk*, as those members have been members in a many *Shari'ah* boards all over the world that deal with *sukuk* structures. Moreover, they are without exception also members of AAOIFI so that their knowledge and views tend to contribute towards improving the quality of the study.

Moreover, among the reasons that have encouraged the researcher to choose SABIC *sukuk* is the similarity between the structure of SABIC *sukuk* and those of the other structures such as the *sukuk* of the Saudi Electricity Company (SEC) with its three issues. In particular, given that the *Shari'ah* board of the SEC is the same as that of SABIC *sukuk* so that SABIC and the Saudi electrical company become the biggest two companies in the Saudi market with regard to the number of issues and the values that have been approved by one single *Shari'ah* board.

Consequently, as far as the exploration of SABIC *sukuk* is concerned, it renders great value regarding structuring of SABIC *sukuk* and the way such structure has been consistent with the AAOIFI standards, which helps understanding highly important views of the Islamic finance related *Shari'ah* scholars in Saudi Arabia, which in many aspects has been associated with *sukuk* structures.

4.4 RESEARCH STRATEGY

Research strategy constitutes another important aspect of research process, which functions to connect theory and data. In other words, mechanism and direction of establishing a connection between data and theory defines research strategy.

As far as social research is concerned two research strategies exist: deductive and inductive methods of reasoning (Saunders *et al*., 2007). In this respect, Bryman (2015:21) suggested that "deductive theory represents the commonest view of the nature of relationship between theory and social research. On the basis of what he knows about in a particular domain featuring the theoretical consideration in relation to that domain, the researcher deduces a hypothesis that must be subject to empirical scrutiny". He goes on to elaborate that the researcher initiates his research with a theory relevant to the topic of research, only to be confined to a specific hypothesis to

be investigated. In the end that will enable the researcher to examine the hypothesis against specific information with the objective of drawing conclusions favouring or otherwise disfavouring the hypothesis. In the same context, Miller (1998) suggests that in deductive analysis the researcher moves from the more general to the more specific through testing the validity of the hypothesis.

As regards to inductive approach, the reverse is true as the researcher moves from the more specific to the more generalised (Bryman and Bell, 2003). To be more precise, the researcher starts with specific observations to produce tentative hypothesis to be investigated to develop a general theory (Blaikie, 2007). Thus, the researcher can draw conclusions featuring the behaviour and characteristics of an entire population through studying a random sample of that population and by using inductive method of reasoning.

As regards to this research, inductive research strategy is considered to be the most efficient research design, as this research aims to collect data from the field and then it aims to make some generalisations through meaning making and establish some patterns that governs the responses provided in relation to the subject matter. In other words, since this research does not aims to deductively developed hypotheses, but rather aims to explore the patterns governing the field or the subject matter, it is, therefore, designed as an inductive research.

4.5 RESEARCH METHOD

Research design and research methods are important elements of any research study featuring the overall research planning and means of data collection and data analysis (Saunders *et al*., 2007). In line with this, Cohen *et al*., (2007), and Payne and Payne 2004) describe research methods as a set of tools to be used by researchers to collect and analyse data, which assists in answering the research questions. Therefore, Jankowicz (2000) refers to research methods as tools for gaining information through a systematic and orderly approach featuring data collection and data analysis. Thus, regardless of the way it is defined; research methods feature data collection, data analysis as well as the sampling of the relevant variables.

It should be mentioned that Miles and Huberman (1984) identify two types of research methods as data collection and data analysis method, which determine the

type of data collection methods to be used. Those are either quantitative or qualitative research.

Qualitative research features descriptive data that does not include numbers or questions (Sekaran, 2003). In other words, qualitative research usually uses inductive methods of data collection such as interviews and observations. Quantitative research on the other hand, features numerical data that can be represented in a graphical format. According to Creswell (2013), the idea of using variables is considered central for quantitative research design so that quantitative methods need to be used for measuring and comparing variables. It should be noted that regardless of the type of research method, Silverman (2000) points out that research method is always a function of research strategies.

Concerning this research, as mentioned above, qualitative methods of data collection featuring interviews is employed, which is consistent with the purpose of research, as it aims at examining the validity of *sukuk* contracts with respect to *Shari'ah law* and legal frame in Saudi Arabia as well as with respect to the AAOIFI standards through the perceptions, opinions and positioning of the *Shari'ah* scholars as well as other stakeholders such as financiers, academics and technocrats at the bureaucracy due to their involvement in the process. The data that has been gathered from structural interviews are integrated with secondary data from academic articles, reports, and SABIC *sukuk* brochure. In addition, interpretative method as a qualitative method is also used to analyse the data.

It should be noted that drawing a line between qualitative and quantitative research methods remains a difficult task. However, it could be maintained that generally speaking, qualitative methods become important in cases of exploratory, descriptive or evaluative research, while quantitative methods are mostly used in cases where explanatory research becomes involved. Having said that, the use of quantitative methods for descriptive and evaluative purposes should not be completely ruled out. Thus, a combination of the two types is often used by social scientists to improve the outcome of the research (Tashakkori and Teddlie, 1998). In this respect, Kothari, (2004) is of the opinion that qualitative knowledge in terms of social settings could become useful in the understanding of patterns of quantitative data. In addition, it is easily possible to transform data from one type to another; for example, words and

phrases imply the transformation of data from the qualitative to the quantitative form. The same could be said about counting frequencies of specific behaviours in qualitative studies. Thus, the use of qualitative and quantitative methods could be very subjective depending on the course and purpose of research.

4.5.1 Data Collection Method: Interviews

The data acquired for conducting a research can be in the form of either primary or secondary data: the secondary data could be obtained from already existing literature sources no matter being published or otherwise (Saunders *et al*., 2007). As for primary data, they can be developed from survey, namely interviews, questionnaires, focus groups and observations. As explained, the use of primary data constitutes the main aspect of this study.

As Churchill (1983) and Bryman (2015) states primary data would be most suitable for social studies where opinion, attitudes, knowledge, and intentions of participants become important. This rationalises as to why primary data is important for this study, as it seeks opinions, understandings and perception of the participants on specific topic, namely emergent *shari'ah* and legal risk issues in *sukuk.*

It should be noted that numerous techniques exist for collecting primary data depending on the nature and objectives of the research study. In choosing a particular method, attempt should be made to select the most suitable instruments that deliver the best outcome when designing and formulating the chosen research methods (de Vaus, 2007). As rationalised above, this research utilises interviews as a qualitative research method. Therefore, by selecting the appropriate technique the researcher was able to obtain suitable data that render the research findings realistic, reliable and credible (Fisher, 1925).

Churchill (1983) identifies two qualitative method for gathering primary data, which are either through communication or observation. Through communication, the researcher can ask questions to obtain the required data. On the other hand, the researcher can record behaviours, actions, facts *etc*. through observation of the participants involved without the need to communicate with them in a direct manner. Communication can either be through interviews or questionnaires.

It should be noted that the interviews have been the most useful qualitative method to be used for explorative studies (Silverman, 2010). As Babbie (2010) puts, interviews allow researchers to acquire data that would be impossible through other means including observation. Trull and Phares (2001) define interview in terms of interaction between two persons where each one plays its role in the process, whereas Busha and Harter (1980: 78) define interview as a "method where information could be gathered from persons as to provide research data in terms of their background, in relation to their experiences, opinions, attitudes, relation to service *etc.*".

In terms of advantages, interview method is described as the easiest way of obtaining people's opinions; thus, according to Punch (2006) interviews remain the most effective way of understanding other people. In addition, King (1994) states that interviews can address direct questions related to life including personal decisions. Nonetheless, there are certain disadvantages with interview method such as time and travelling it may require. In other words, interviews are considered time consuming particularly when researchers have to meet a specific deadline. Thus, it is highly recommended that interviews should not cover areas than they really have time for to meet a particular deadline set for the study (King, 1994).

This research utilises interviews in generating primary data, they are focused on *Shari'ah* and legal issues associated with SABIC *sukuk*. Thus, qualitative method of semi-structured interviews was employed to interview *Shari'ah* scholars, Islamic finance experts, judges, lawyers, academic staff and people involved in CMA in relation to *sukuk*. The main purpose of the interviews in this research was to gather information with regard to the emergent *Shari'ah* and legal risks in the case of defined case, SABIC *sukuk*.

4.5.1.1 Types of interviews

As indicated by Bryman, interviews could be in the form of structured, semi-structured or even may be unstructured. In addition, interviews could be in the form of group of interviews (Collins, *et al*., 2004).

A structured interview is basically considered as a questionnaire with a multiple questions to be prepared beforehand (Gratton and Jones, 2004). The answers of these questions are then given out by the interviewees for the researchers to write them

down or to record. The interviews are also take place face to face or might be given indirectly without personal contact between the interviewer and interviewee. That gives the structured interviews the edge over others by giving the interviewer the chance to clarify vague questions (Gratton and Johns, 2004). Nonetheless, the fact that the limited answers might be a disadvantage as the interviewee might fail to explain his views more clearly (Miller and Salkind, 2002).

As for unstructured interviews, they could sometimes be useful in cases, where the researcher fails to prepare his questions before hand and in which case such interviews might resemble ordinary conversation and the outcome might not be clear (Polit and Beck, 2004). However, in such cases the researcher has only a broad guideline about the subject to be discussed where the respondents take control of the discussion. It should be noted that such types of interviews are not suitable for this study due to exact guidelines that determine how the course of the investigation could be managed and that the interviewees are encouraged by guide questions to develop particular responses. Having said that the semi-structured interviews are mostly unstandardised but more focused than unstructured ones.

It should be mentioned that among the reasons for choosing semi-structured interviews in the conduct of this research is that it gives the researcher a chance to explain the questions to the interviewees as to follow responses where appropriate (Leedy and Ormrod, 2005); and also it rendered particular responses from different stakeholders on the same issue.

In addition, semi-structured interviews helps to gather information to a greater depth as to allow a better understanding of the interviewees practice and interpret reality, by making the ideas, thoughts and memories of the interviewees in their own words (Klandermans and Staggenborg, 2002); as semi-structured interview allows to personalise the questions when it is necessary. Furthermore, through semi-structured method, the interviewee is allowed to express his views in a more explicit manner to effect of making their own suggestions. While face-to-face interviews allows interviewers to persuade participants to the extent of clarifying specific points in favour of the final research outcome.

In fact semi-structured interviews can either be carried out directly face-to-face or indirectly through communication channels for which new technologies can be rather effective. As Sekaran (2003) puts it, the face-to-face interviews has the advantage of allowing the interviewee to clarify any possible doubts associated with the interview through repetition to clarify vagueness. This is not to mention the fact that face-to-face interviewers can help each side to understand non-verbal cues such as body language, a matter that would impossible over the phone. The down side of face-to-face interviews is that they are costly with no privacy or anonymity something that makes respondents to become discouraged to answer personal questions as they might feel embarrassed or even threatened in taking part in interviews on sensitive issues. Moreover, the interviewees might be influenced by the interviewers in terms of his answers (Kumar, 2005).

As regards to this research, semi-structured face-to-face interviews were utilised due to the listed advantages in line with the research questions and process identified so far. Having the fact-to-face interviews enabled the research to fit into the development of semi-structured interviews with ease and also helped to developed mutual confidence, which increased the effectiveness of the interviewees.

It should be mentioned that the interviews in this research should be considered also as elite interviews in the sense that interviewee sampled included very high profile *Shari'ah* scholars, specialists, technocrats, lawyers, finance professionals and academics. They are considered as reputable and respected members of the Saudi Arabian society.

Lastly, due to the nature of the interview administration process, and the detailed discussion it involved, the interviews in this research should be considered as in-depth interviews. As informed in a later section, some of the interviews took as long as three hours, which gave an opportunity to explore the issues rather in detail.

4.5.1.2 Designing the semi-structured interviews

In terms of interview schedule design, the particular interview schedule used in this study is consisted of three parts, whereby the first part gathered personal information about the interviewees such as name, address, position, institutional affiliation *etc*., while the second part of the interview schedule tended to gather general information

from interviewees about *sukuk* and risk management. The last section of the semi-structured interviews focused on investigating and exploring *Shari'ah* and the legal risks in the case of SABIC *sukuk*.

It should not be noted that interview design for the *Shari'ah* scholars involved in the structure and approval of the SABIC *sukuk* was designed in two particular parts. The first part aimed at investigating the nature of their work in relation to the approval of SABIC *sukuk*, while the second part focused on the prospectus of issuance of SABIC *sukuk* and the structure on which SABIC *sukuk* has been based on.

Designing the first draft of questions is the first challenge for the researcher. The first draft might include long and general questions taking into account the fact that the first phase could include developed and elaborated questions. Then, the final stage will see the final drafts being displayed before a group of specialists and expertise including judges and academics to approve the final version of the interview questions.

The questions have initially been designed to include a comprehensive answer to the research question featuring the legal and *Shari'ah* risks that *sukuk* structures might be exposed to and that have been issued in the Saudi market especially the study of SABIC *sukuk* and ways to deal with matters to avoid the identified risks. The questions were shown to the supervisor, who had taken part in the discussion of the questions by contributing to their development as to become more accurate to achieve the aims for which it has been designed for.

However, after a suitable design had been achieved for the questions directed for the three groups of interviewees, the questions were examined by three of the academics and their comments have been taken into account. The questions had been then again shown for the second time to the supervisor who has taken part in the discussion of the proposals that had been presented and some of these proposals had been considered and the supervisor finally approved the interview questions.

A copy of the interview schedule can be found in the Appendix section.

4.5.1.3 Sampling

In order to select the suitable sample, the researcher had to seek the advice of specialists including those experts in finance and law, *Shari'ah* scholars, law and judges, who helped to select of the right sample. Consequently, in the sampling process, the target sample was identified as three groups of participants given that every group relates to a particular part of the research.

The first group of participants were considered as Islamic finance and law specialists, for which the selection required the researcher to choose from a number of specialised individuals before nominating those who have some writings featuring *sukuk* or those who work in the area of *sukuk* taking into account those who have writings associated with SABIC *sukuk* which are the subject of this research.

As for the second group consisting of *Shari'ah* board members, this study managed to get three such participants whose selection has been rather easy, as they have direct relationship with SABIC *sukuk* by being members of the *Shari'ah* board that approved SABIC *sukuk.*

The third group has also been difficult in terms of its selection, as the most important selection for this group is that they must have the knowledge of the laws and systems in relation to the issuance of financial papers in the Saudi Arabian market and all systems associated with the jurisdiction and the Committee for the Resolution of Securities Disputes (CRSD) and the Appeal Committee for the Resolution of Securities Conflicts (ACRSC), the latter being the only legal authority that has been authorised to investigate cases of dispute involving *sukuk.* In addition, awareness of the work of judges of *Shari'ah* courts in Saudi Arabia is another criteria utilised to select participants for this group.

In should be noted that experts who contributed to the selection of the sample are chosen of their expertise and judicial level in terms of seniority. Thus, among the experts were the members of SABB *Shari'ah* board who had approved SABIC *sukuk.* Thus, the contribution of such experts provided a good chance to reach accurate conclusions that might reflect the right application in Saudi courts as well as the CMA. Therefore, the above mentioned experts and particular areas of questions they were requested to respond are as follows:

(i) Five of the interviewees in this group included a *Shari'ah* scholar who is expert in *sukuk*, an academic who is a professor at SABIC in charge of Islamic funding research. In addition to a judge in a Saudi court, an expert in Islamic banking who showed a great interest in Islamic *sukuk*, and one of the law experts who is interested in *sukuk* structures in legal and *Shari'ah* terms.

These expert participants were asked questions about *Shari'ah* boards and their importance with respect to *sukuk*, as a new product in the Saudi market, and also the work of the *Shari'ah* boards with regard to approving those products. The enquiries were also extended to cover cases involving *Shari'ah* boards as the mechanism for issuing *fatawa* and the criteria of the board members and the responsibilities of the members as well as their opinions on *Shari'ah* risks that *sukuk* might be exposed in relation to *Shari'ah* boards and their work in Saudi market.

(ii) The second group included three interviewees representing the members of *Shari'ah* board for SABB *Amanah* Bank, who have approved the SABIC *sukuk*, as SABB Bank is considered as the issuer of SABIC *sukuk*. Those three *Shari'ah* scholars have been joining a great number of *Shari'ah* boards featuring banks and financial institutions in addition to AAOIFI. It is worth mentioning that two of the members are considered as a consultant for the King of Saudi Arabia working at the Royal Divan.

The interviews with those members were mainly attempted to identify the nature of their work as members of the *Shari'ah* board that had approved the SABIC *sukuk* and their views about the AAOIFI standards in addition enquiring about the SABIC *sukuk* structures and to identify their views regarding the problems and the risks in terms of *Shari'ah* to which *sukuk* structures have been exposed and their presence in SABIC *sukuk.*

(iii) Given the fact that the third part of the research deals with the issue associated with legal risk to which the Islamic *sukuk* might be exposed in general and SABIC *sukuk* in particular, three interviewees were chosen as potentially effective individuals who could answer questions for this section of the research. One of them represents the manager of appeal studies featuring the CRSD and ACRSC at the SAMA, the advisor and the Dean of the Faculty of law at one of the Saudi universities, and the

other one representing an academic law expert specialised in *sukuk*, and the third one is an employee from one of Riyadh *Shari'ah* courts interested in legal aspects.

The main aim of the interview with the participants in this section was to explore the laws associated with financial market in Saudi Arabia regarding issuance of *sukuk* in general and SABIC *sukuk* in particular, in addition to making attempts to identify the reference law for SABIC *sukuk* in case of dispute between *sukuk* holders and the issuer and how the *Shari'ah* courts deal with *sukuk* featuring *Shari'ah* disputes and also the legal risks to which SABIC *sukuk* might be exposed in the Saudi market.

Table 4.1: Sample and Administering Interviews

No	Interviewees' position	Location	Interview Date
Interviewee 1	The members of SBSS	Makkah	03-08-2013
Interviewee 2		Riyadh	07-08-2013
Interviewee 3		Riyadh	15-08-2013
Interviewee 4	Specialists in Islamic Finance and *sukuk*	Riyadh	18-08-2013
Interviewee 5		Riyadh	22-08-2013
Interviewee 6		Riyadh	25-08-2013
Interviewee 7		Riyadh	28-08-2013
Interviewee 8		Jeddah	04-09-2013
Interviewee 9	Legal participants	Riyadh	08-09-2013
Interviewee 10		Riyadh	13-09-2013
Interviewee 11		Riyadh	20-09-2013

It should be noted that this research managed to interview a total of 11 participants, in the form of elite and in-depth interviews representing various specialities as has already been mentioned; and the interview questions can be found in Appendix 1.

Table 4.1 provides a list of interviewees, their locations, their affiliations and the date the interview conducted. The names and institutional affiliations have been kept confidential in line with the assurances given to the participants.

4.5.1.4 V*alidity of the interview schedule and pilot study*

In order to verify the clarity and comprehensiveness of the interview questions to achieve the desired goals of the research, a pilot study was conducted with selected interviewees. This pilot study is also considered as a verification and validity process for the questions included in the interview schedule.

This sample in the validity and hence pilot study included two types of sampled individuals. The first group consisted of three specialists in English language with their mother tongue being Arabic. The questions were provided for them in both Arabic and English languages to validate the translation for the clarity of the recipient and quality assurance. The second group consisted of three people being specialists in Islamic finance, who had been requested to review interview questions from Islamic finance perspective and make sure they would support the overall aim of the study by enabling sampled interviewees to answer the research questions in an efficient and comprehensive manner.

The feedback provided by these two specialists group helped to enhance the questionnaires in terms of Arabic language and also in terms of Islamic finance related contents. After refining the questions in the interview schedule in relation to aims and objectives of the study, the pilot study proved the efficiency of the interview process, which also helped to develop an idea as to how long the interviews would take. Importantly, the pilot study helped to develop the questions to be formulated in a clearer and more comprehensive way by helping to develop the questions in an understandable manner by the interviewees.

All these measures were under the supervision of the supervisor who in followed the process of formulating the questions to be comprehensive and clear manner which to determine the aims of the study.

4.5.1.5 Administering the interviews

Given that the research is associated with *Shari'ah* and legal aspects of *sukuk* in Saudi Arabia in general and SABIC *sukuk* in particular, that required approaching the *Shari'ah* board members that has approved SABIC *sukuk* was an essential task not to mention the fact that one of those who belong to the Saudi financial market has also

been approached. In addition, the interview questions have been presented to *Shari'ah* scholars and legal experts as well as to the Islamic banking experts in addition to the academics and the judges of Saudi courts who are closely associated with *sukuk* either through their work or otherwise through scientific writings or through their contribution in the scientific conferences.

The interviews were conducted through two-field research from July 2013 to September 2013 in three cities, namely Riyadh, Makkah and Jeddah, which are the locations where the interviewees resided. The interviewees were given the option to choose the places for conducting the interview in order to make the interview process easier for them: some were interviewed at their own home, while others were interviewed at their offices and a third group was interviewed either at hotels or at cafes.

The duration of interviews extended from one to three hours for every interview and that long interviews were specially conducted with the members of *Shari'ah* board members that approved SABIC *sukuk* for the simple reason that the questions that have been prepared for them have been of two parts, as described above.

It should be noted that after identifying all the names required for interviews, a suitable way was explored to establish communication with the sampled names. Consequently, contacts were made with a number of friends in order to obtain the telephone numbers of the interviewees, while others have been contacted through e-mail. Then, after all the interviewees were contacted to fix a date of the interviews, a time table was made for every interviewee and all paper work was prepared including the recording system.

It is worth mentioning that prior to conducting the interviews the researcher had to establish a friendly relationship with potential participants. That idea has been proposed by Sekaran (2003), who suggested that the researcher has to be credible and that rapport can encourage interview to provide genuine answers and that could minimise bias, so that according to Sekaran (2003), the interviewers have to avoid asking biased questions during the process. In this regard, the general and easy questions should be gradually followed by the interviewer whenever that is possible. In addition, interviews have to be immediately recorded to avoid loss of information

through time, which is considered as aiming at getting more reliable data (Sekaran, 2003).

In making respondents more focused, the researcher reassured the interviewees that all information would remain confidential, and interviewees should decline to answer any questions that they might not be interested in where the interview session might not last for more than one hour and that can stop the interview at any time during the session whenever they lose interest. The interviews were usually tape recorded to avoid any loss of information as well as the full transcript for all the participants were given a code to keep confidential.

As part of the interview process, in the beginning, the researcher introduced himself to those participants who did not know him, and gave a brief explanation of the aims of the interview with the hope that an efficient and effective interview could be run. For this, one of the following approaches utilised according to the dictation of the situation (Punch, 2013; Seidman, 2013):

(i) to avoid boredom and tiredness, a friendly environment and process was ensured by the researcher;

(ii) The researcher assured all his interviewees that everything would remain confidential including the names to guarantee their free responses.

The mechanism of the interview was designed to include a short presentation by the researcher on a briefing the interviewee on the idea of the research including the aim of the study, the subject of the study, the approach of the research and purpose of the interview by informing the interviewees that the interviews were only for reserach purposes. The interviews were conducted in Arabic and then latter were translated and transcribed into English.

4.5.2 Data Analysis

Data analysis constitutes the essence of any research study. In this sense, the accuracy of data analysis is a crucial matter for the credibility and accuracy of the research findings (Lewis-Beck, 1995). In other words, choosing the suitable techniques for analysing the data tends to guide the researcher to the right interpretation for the final results, and eventually will reach a meaningful conclusion (Kumar, 2002). This

implies that any errors associated with data analysis would eventually lead to the wrong conclusions. For that reason, researchers always need to pay attention to data analysis as to select the appropriate research methods to meet the research objectives.

As mentioned above, this research mainly utilises qualitative data in the form of secondary data through interview schedule and documents, respectively. The methods of analysis in relations to these are discussed in the following sections.

4.5.2.1 Content analysis

As mentioned above, a number of various sources of secondary data were also utilised in the conduct of this research, which were sourced from various sources, such as government reports and other sources related to companies and financial organisations. For this research study, secondary data were acquired from published reports compiled by CMA on *sukuk* management in Saudi Arabia as well as reports from around the world featuring licensed Islamic financial institutions. Thus, in addition to published reports, bank magazines, the internet, professional and academic conference materials were also consulted and examined in order to acquire up-to-date information on the development and progress of the Islamic banking and finance in general and *sukuk* in particular.

The most important document subjected to analyse in this research features the prospective relating to the issuance of SABIC *Sukuk* No 3 together with the summary of the prospectus of issuance approved by its *Shari'ah* board in addition to the documents attached to the prospectus of issuance not to forget mentioning the fact that the prospectus of issuance 1 and 2 were also reviewed and examined.

In the analysis of the documents acquired for this research, content analysis was used. As part of qualitative and unobtrusive research, content analysis mainly related to written and published documents. The aim in such analysis within content analysis is to understand the participants' categories and the way through which theu communicate a particular activity; in this case, constructing a *sukuk* structure, namely SABIC *sukuk*.

Content analysis is defined as "a research technique for the objective, systematic and quantitative description of the manifest content of communication" (Berelson, 1952:

18). Thus, it aims at revealing the specified characteristics of messages by "systematically analysing and making inferences from text" (Weber, 1985: 9). In the case of this research, SABIC *sukuk* prospective is considered as the unit of analysis constituting the examined text along with other supporting documents and literature material.

In conducting the content analysis, mainly texts, including the prospective of SABIC sukuk, were scrutinised carefully to develop an understanding of the process of generating the *sukuk* in question, its issuance and related *Shari'ah* compliance and financial issues. In the analysis, pre-determined or structured categories were not utilised, but rather documents including the prospectuses and their appendices were examined with an open mind to understand the communicated message, namely the explanations on the construct of SABIC *sukuk*, working mechanism and the process of construct including the *Shari'ah* scholars involved. Thus, in the coding process, rather than imposed or pre-determined codes, emerging codes were utilised (Krippendorff, 1980); and the process of recognising such emerging codes is informed through the knowledge developed on the subject matter through the research process. In examining the material and in particular the prospectus and the attached documents, manifest items that were physically seen in the documents helped as a guide to develop the interpretations or the latent contents with the recognition that documents including the prospectus communicate socially constructed yet objectively produced social artefacts, communications or structures that involves various agents and their negotiations, namely, in this case, *sukuk* structure.

The developed material was then utilised in articulating and writing such matters in the formation of this thesis. Thus, content analysis method was utilised in the examination of literature material and importantly the SABIC *sukuk* brochure and the attached material.

4.5.2.2 Interview data analysis

A qualitative method is used for the analysis of the collected data through the interviews where the data were transcribed following each interview, as is advised by Sekaran (2003). However, due to the delays in the interviews and considering the size and length of the interview material, the transcription process was completed two months after the data had been collected.

In the analysis of the transcribed data from the interviews, thematic analysis was used, which provides a coherent way of reading and organising some of the interview material associated with specific research questions. As Banister (2011) puts it, thematic headings to do justice to both the research elements as well as to preoccupations of the interviewees. The interviews were coded according to the themes of the research, which allowed the researcher to respond to the particular aspect of the research through insider insights provided by the interviewees.

In the thematic organisation of the material developed from interview based data and textual data, an interpretative method was utilised to analyse the material transcribed from the interviewees. This assumes, philosophically, that the interview material was socially constructed and they were further subjected to social constructionism through the understanding of the researcher. Hence, the analysis presented in this research is a reflection of this particular process. In addition, in rendering meaning making through interpretative method, in each of the empirical chapter, critical reflections were provided by subjecting the findings to further analysis.

4.6 LIMITATIONS AND DIFFICULTIES

It should be noted that many challenges and limitations have been faced through the period of conducting this research, which are listed as follows;

(i) Preparing the questions and classifying them into three sections, which is also true for the transcribed material;

(ii) Searching for the sampled participants and communicating with them was a real challenge which required a great effort particularly the *Shari'ah* board members who approved SABIC *sukuk*, as two of the members are permanent advisors of the King making them not settled in one city, as the researcher found later that each member stays in a different city including Riyadh, Jeddah and Makkah.

(iii) In order to protect anonymity due to the sensitivity of the issues, some of the interviewees had declined to allow the researcher to record the interview so that the researcher had no way but to write down the interview during the sessions;

(iv) There were too many detailed questions for the purpose of reaching the right answers of research questions, which resulted long interview schedules.

(v)The rarity of the studies in relation to *sukuk* with regard to legal and *Shari'ah* risks involving *sukuk* structure made it difficult to conceptualise the study in general and interview schedule in particular.

(vi) The difficulty of interviewing high profile professionals including members of *Shari'ah* board of SABIC *sukuk* should also be acknowledged.

Chapter 5

RISKS ASSOCIATED WITH *SHARI'AH* SUPERVISORY BOARD

5.1 INTRODUCTION

In the last few years, the developments in Islamic financial markets have witness many debates and arguments mainly over *sukuk* from *Shari'ah* and legal perspectives. For example, some contenders from *Shari'ah* scholars criticised *sukuk* structures by arguing that the idea of *sukuk* has been inconsistent with *Shari'ah* law. That view might have accounted for the decline of *sukuk* market in the aftermath of the financial crisis in 2008. However, the main debate remains is as to whether *sukuk* structures are different to conventional bonds or not. As far as the Islamic financial transactions are concerned, *sukuk* represent a new and innovative product for financial investment. Thus, given the complexity of the Islamic finance and the associated products including *sukuk*, it is quite natural that new products become problematic in terms of *Shari'ah* and other legal matters.

One of the important areas raised in particular in the aftermath of the financial crisis is risks in Islamic finance and its management. In particular the existence of *Shari'ah* Supervisory Board (SSB) overseeing the *Shari'ah* compliancy of any Islamic financial products is potentially concerned to be a source of such risks in Islamic finance. This is particularly true with *sukuk*, as the premature birth of Goldman Sach *sukuk* particularly indicated. Hence, the SBB and its member and their actions and credibility can be a source of major risk for the issuance and successful completion of *sukuk*.

Being the first empirical paper of this research, this chapter aims at exploring risks associated with the SBSS who was in charge of approving the structure and the issuance of the SABIC *sukuk*, which is the case study in this research.

In organising the chapter, first section discusses the importance of the *Shari'ah* supervisory board in Islamic finance in general and *sukuk* in particular and the risks associated with it. The second part presents the primary data collected through interview survey from the field with the specialists in *sukuk* structures with regard to

the significance of SSB. The third section shifts the discussion to SBSS by discussing the primary data collected through interview survey from the field in relation to the duties of SBSS in approving and structuring SABIC *sukuk* as well as related issues. The last part of this chapter aims to develop an interpretative discussion by delving into the identified risks which SABIC *sukuk* could be exposed to from the time of issuing till the maturity.

5.2 RISKS ASSOCIATED WITH SSB: AN OVERVIEW OF THE LITERATURE

In this section, critical issues related to SSBs are highlighted and discussed with the objective of providing a foundation base for the discussion through primary data presented in the following sections. In this regard, it is essential to identify the conceptual nature of the SSBs, the function of SSBs and their responsibilities with regard to their role of evaluating the *Shari'ah* risks related to *sukuk* structures. In doing so, recent criticisms with regard to *fatwa* and the related issues are also explored and underlined.

5.2.1 The Concept of SSB

In re-iteration, an essential aspect of any Islamic financial product is the *Shari'ah* complicacy to ensure that the Islamic financial products, instruments and services are structured, constructed and approved according to the *Shari'ah* principles. In modern times, this process in IBF is provided by SSBs and within that with the SBSS. Therefore, the existence of SSB and its approval for any product to be presented to investors is an important matter according to AAOIFI (2010).

The SSB is defined according to AAOIFI (2010) as 'an independent body of specialized jurist in *fiqh al mua'malat* (Islamic commercial jurisprudence)'. In addition, the decision of the Islamic *Fiqh* Academy's No 177 (3/19) also stated the same definition. This implies that the main duty of SSB is to support the Islamic financial institutions with supervision, guidance and direction (Nuhtay and Salman, 2013). In supporting this, DeLorenzo (2006) pointed out that the purpose of having SSB in Islamic banks and financial institutions are to ensure that all transactions should be based on *Shari'ah* standards.

While the everyday experience in IBFIs indicates that in most cases as in the case of *sukuk*, the roles of SSB' are confined to the approval of *sukuk* for business dealings (Al-Sayed, 2013), according to the AAOIFI (2010) it has been stated that SSB

> Should not limit their role to the issuance of *fatwa* on the permissibility of the structure of *sukuk*. All relevant contracts and documents related to the actual transaction must be carefully reviewed {by them}, and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with *Shari'ah* guidelines and requirements as specified in the *Shari'ah* Standards. The investment of *Sukuk* proceeds and the conversion of the proceeds into assets, using one of the *Shari'ah* compliant methods of investments, must conform to Article (5/1/8/5)7 of the AAOIFI *Shari'ah* Standard (17).

This AAOIFI standard, therefore, implies that it is not enough to have SSB to sign the approval of any structure of *sukuk* in the first stage, as those committees should follow up the application of the associated structures as well as the steps involved in relation to the issuance of *sukuk*, and in effect would decide the legality of the *sukuk* in terms of *Shari'ah* law. Thus, the focus of SSB in giving the legal advice (*fatwa*) on *sukuk* business without paying attention to the follow up of the practical application will constitute a great risk which should be avoidable (Faishal and Akinsomi, 2012). In other words, the failure of SSB in undertaking their real role regarding the follow up of the different stages of *sukuk* issuance could result in *sukuk* violating the *Shari'ah* principles due to the missing of due diligence (DeLorenzo, 2006). In this regard, AAOIFI (2010) as well as the Islamic *Fiqh* Academy's Decision No 177 (3/19) suggested that Islamic finical institutions should have internal *Shari'ah* review, which is defined according to AAOIFI as;

> an examination of the extent of an IFI's compliance in all its activities [which must include] the contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, *etc.*'

It can, therefore, be stated that the objective of such review is to make sure that all the transactions are according to the *Shari'ah* principles as the *Shari'ah* committee is responsible for expressing as well as forming a view on the extent of an IBFI's compliance with the principle of *Shari'ah* (Nuhtay and Salman, 2013).

In addition, it can be argued that the lack of the clarity in having SSB in the mind of *Shari'ah* committee members as well as the management of the Islamic banks may

lead to the emergence of risks associated with *Shari'ah* supervision (Yaacob, 2012), as this might lead to losing the right direction and forgetting the main duty and responsibility of having an SSB (Abu-Ghudah, 2003). This consequently may lead to *Shari'ah* supervision becoming imaginary and meaningless. In this respect, Alroshood (2013) suggested that the SSB should be more active with regard to review as well as examine all structures under their investigation, as their duty does not confine to issuing a statement of 'permissibility' in the sense of providing instrumental legitimacy as they are expected to provide moral substance to the process by also fulfilling the form requirement with it fullness.

On the other hand, it should be mentioned that the level of the understanding of most of the SSB of the reality of the contemporary economy and its innovations, as well as their knowledge about banking and financing matters is not equal to the level of their knowledge and their expertise on *Shari'ah* matters (Bose and McGee, 2008; Yaacob, 2012; Hasan, 2012). This could lead to the rejection of many models and the format of financing transactions, for which there might not be a substitute for it in the literature of Islamic jurisprudence. In this regard AAOIFI (2010) suggested that 'the *Shari'ah* Supervisory Board may include a member other than those specialized in *fiqh mua'malat*, but should be an expert in the field of Islamic financial institutions (IFIs) with the knowledge of *fiqh mua'malat'.*

Moreover, the regrettable fact is that until now an a systematic and sophisticated system for the follow up of the application of *sukuk* product from its initiation to post-issuance process in relation to *Shari'ah* compliance is non-existent. In addition, according to Ahmed (2011), the pressures that may be exercised by the banks managers on the board in order to pass legalization verdicts in favour of some of the financial transactions and activities due to their misperceptions of the knowledge level of SSB about the banking transactions can lead to unwanted consequences. All these and other implications may result in Islamic finance being exposed to risks that are related to *Shari'ah* supervision, the extent of its effectiveness and the difficulty of harmonizing the multiple *fatawa* of the banks together (Izhar, 2010).Therefore, it can be concluded that the lack of efficient and effective *Shari'ah* supervisory process as well as the aim and purpose of SSB in IFBs is still need to be addressed and defined.

5.2.2 The Lack of *Shari'ah* Experts

It could be noted that one of the critical issue in the area of *sukuk* is the scarcity of specialists in *sukuk* structures, whether those specialists are *Shari'ah* scholars or academics who combine between the *Shari'ah* knowledge and the other knowledge that could assist to have a full understanding of the complexity of *sukuk* structures (Yean, 2009). The main role of those specialists according to AAOIFI standards is to review the *sukuk* that have been issued as to whether or not they comply with *Shari'ah* principles. If not then the *sukuk* will be rejected as an Islamic product; in which case all parties involved will be affected regardless of being funders, the *sukuk* holders or the market as a whole (DeLorenzo, 2006). Nonetheless, from a legal point of view, the lack of specialists to monitor *sukuk* contracts will render those contracts legally flawed, which would mean vagueness in terms of rights and obligations of the parties involved, in which case both *sukuk* issuers and *sukuk* holders would be in risk, a matter which should be avoided (Aoudah, 2010).

On the other hand, the increasing demand for *Shari'ah* compliant products as compared to the number of specialists reveals a huge deficit in the latter so that the need is urgent to make up for the observed deficit in terms of legal committees and other *Shari'ah* organisations involved in the examination and approval of Islamic financial products including *sukuk*. By doing so; those products will be intact in terms of their compliance with *Shari'ah* leading to the avoidance of potential risks involved (DeLorenzo, 2006; Al-Amine, 2008). However, it is noteworthy that the scarcity of Islamic *sukuk* specialists who combine between the knowledge of *Shari'ah* and the legal knowledge has serious impact on the studies and research associated with *sukuk*. In addition, research centres in the Islamic finance related research are effective enough in themselves to be able to communicate with the industry to work for solutions, which is in itself a setback that should be given great attention. Yet, in order to avoid all the above risks, or at least keep the damage to the minimum in case they happen, should imply a better understanding of the nature of *sukuk*, and the way they work as well as the risks involved in terms of *Shari'ah* and other legal and financial aspects as that will not be possible without establishing the appropriate and adequate research centres featuring specialists in *Shari'ah* and other legal matters who will study the *sukuk* structures from all aspects before they are finally approved for public by potential investors (Balz, 2008). In addition, Van Greuning and Iqbal (2008)

argued that Islamic financial institutions need *Shari'ah* scholars who can understand finance and banking system. In this regard, considering that the top 20 scholars serve more than 500 boards globally which means that the number of *Shari'ah* experts is limited (Zawya, 2015).

It can, on the other hand, be argued that due to the dearth of *Shari'ah* specialists in *sukuk* structures for instance, Islamic banks utilize the services of the trained employees of the conventional banks. That is because of the lack of variation in most of the operations and activities in terms of the procedural requirements and the activities that are carried out in the existing banks, and that of the Islamic banks (Najeeb and Ibrahim, 2014). However, this situation could lead to the mimicry and mirroring in the form of convergence towards the principles and values of the conventional banking. In a similar manner, the consolidation of the concepts of comprehensive security, such as the capital and profit guarantee by the level of the lowest possible risks, may result in the lack of the caring of administrative bodies of Islamic banks about innovation and the implementation of new models that are complementary to the instruments and the current models (Iqbal, 1997). Therefore, Islamic banks are in dire need of training elements. Such training will prepare qualified personnel for the ability of carrying out an economic feasibility study of production projects and seek the assistance of qualified experts to oversee the production projects in which they invest (Erol and El-Bdour, 1989).

This challenge is usually blamed on the level of the availability of technical staff and specialized professionals that are trained to work on the harmonization of the prevailing law and the *Shari'ah* rulings (Hasan, 2011). Such experts will also be able to perform legal expertise tasks combined with the minimum level of *Shari'ah* knowledge, which will assist them on the management and implementation in a better way, without the violating the rules of *Shari'ah* (Yahya and Mahzan, 2012). Similarly, in the area of the actual activities, the cooperation between Islamic banks in the area of the provision of technical personnel and banking expertise is still in narrow stage and it is not regular (Izhar, 2010). Therefore, the lack of *Shari'ah* experts and hence their effectiveness in relation to *sukuk* is considered as one of the *Shari'ah* risks that *sukuk* sector might be exposed to.

5.2.3 Multiplicity of Jurisprudence Opinions/Verdicts

The multiple opinions/verdicts and the different *fatawa* that are issued by SSB, on the same banking activities have constituted confusion to the *sukuk* investors as well as to the people who are in-charge of the management of the banks, likewise to the employees (Ahmed, 2009;Yaacob, 2012). However, this might lead to the disruption in the implementation of some banking instruments that provide the banks with operational flexibility, and more active role in enabling the banks to provide the possible maximum banking activities (Iqbal, 1997). In this regard, the Islamic *Fiqh* Academy's Decision No 177(3/19) stated that the SSB's should follow all the decisions made by the Islamic *Fiqh* Academy as well as they should consider what it has been decided in decision no 153(2/17) with regard to the rules of issuing *fatwa*.

It could be argued that the differences in jurisdiction between the various *Shari'ah* committees such as those in the GCC region and Malaysia regarding the legality of selling debts as one of the examples, should pose a great risk to the *sukuk* product in particular and the Islamic finance in general. As a matter of fact, that difference between the sources of *fatwa* has led to the interruption of the development of that product closing the door for the emergence of new methods based on the principle of *sukuk* (McMillen, 2006). In other words, the road has ended with some *sukuk* that have been approved by many *Shari'ah* scholars, while many other types of *sukuk* have been ignored that might have otherwise been more attractive to investors, given the juristic difference regarding their legality among the various *fatwa* sources (DeLorenzo, 2007).

5.2.4 The Legal Opinion (*Fatwa*) and Associated Risks

Some experts in Islamic finances believe that any Islamic product such as *sukuk* could be safe through legal advice (*fatwa*) as to become eligible for marketing locally or internationally (DeLorenzo, 2007; Lahsasna, 2014). In this regard, one of *sukuk* issued in Saudi Arabia has been approved as an Islamic product consistent with *Shari'ah* principles, based on a *fatwa* issued from one of the *Shari'ah* committee. However, later on, it has been discovered by other group of scholars that the *fatwa* has been legally flawed in terms of *Shari'ah*; questioning the consistency of the product with *Shari'ah* principles (Alshamari, 2013). For that reason, it should be mentioned

that a legal opinion (*fatwa*) features a number of risks some of which are the following:

(i) The rejection of *fatwa*

Where financial transactions are concerned, disagreement between *Shari'ah* scholars always exists as unanimity becomes almost impossible (Masud, 2009). That is for the simple reason that such transactions are based on juristic reasoning or otherwise independent judgment, and both constitute major sources for *Shari'ah* legislation (Skubik, 2009). Thus, issuers of *sukuk*, *sukuk* holders as well as *Shari'ah* scholars should always bear in mind the fact that there is a possibility of rejection of *fatwa* sometime after being enforced (Shaharuddin *et al.*,2012). This should make those concerned more meticulous when giving a *fatwa*; a matter which should only happen after careful examination of the contract in question in terms of its compliance with *Shari'ah* principles, and that failure to do so will result in a flawed *fatwa* (Ahmed, 2009; DeLorenzo, 2006). Eventually, that will damage the image of those who have issued the *fatwa* in front of public as well as customers will have no trust on the product in which case both *sukuk* issuers and *sukuk* holders are more likely to pay the cost (Mounira and Anas, 2009).

(ii) Changing the *fatwa*

As it has already been mentioned; the *mufti* (the one who makes *fatwa*) relies on his understanding of the basic *Shari'ah* principles regarding his approval of a particular financial product in relation to their compliance with *Shari'ah* law (Sole, 2007). For instance, in case of *sukuk*, after being structured, they will be referred to the *Shari'ah* committee which is part of the institution that issues the *sukuk*. The committee will examine the *sukuk* as to their compliance with *Shari'ah* principles, and will either approve them or will otherwise reject them accompanied with a report highlighting the areas where they violate *Shari'ah* law. It can be argued that the main risk is that the committee or one of its members might discover sometime after the product has been promoted that some inconsistencies with *Shari'ah* do exist in which case transactions involving such *sukuk* will be unlawful in terms of *Shari'ah* principles. That was exactly what had happened with two of the *Shari'ah* committee members of Bahrain Airport *sukuk* changing their *fatwa* in the case where they initially gave

guarantees to *sukuk* holders that they would be eligible to full refund after *sukuk* expired (Merah, 2008; Almenea, 2010). The same case was repeated with *Sheikh* Usmani who stated that 85 % of the *sukuk* did not comply with *Shari'ah* principles, even though he had been responsible for the approval of many of those *sukuk*, and that many investors and scholars used his *fatwa* as a basis for their acceptance to some kinds of *sukuk* (Shaikh and Saeed, 2010).

It should be noted that, changing of *fatwa* is a complex matter as it could lead to invalidation of the contract (Vogel and Hayes, 1998). In this respect, even *Shari'ah* scholars remain divided regarding some of the Islamic contracts and structures that have been based on *fatwa* issued by *Shari'ah* scholars who have later on discovered their *fatwa* to be wrong, and have retracted from it. The main point of difference is that whether the contract will immediately be invalidated and so will the associated *sukuk* featuring that contract, or should the *sukuk* continue to be valid until they expire. In addition, one would question the legal status of *sukuk* holders in terms of *Shari'ah* assuming that they had made gains from their *sukuk*. In other words, whether those gains are lawful (*halal*) or not, in terms of *Shari'ah*, given the fact that the original contract was legally flawed, or otherwise what they have gained is considered lawful as the *sukuk* was issued by a renowned legal committee and that the reversal of *fatwa* should not affect those gains. Moreover, how do courts deal with such risks? All those critical issues should be given more legal attention in terms of *Shari'ah* law. It is worth mentioning that fears of withdrawal of *fatwa* have had its effects featuring the poor subscription to those products as the risk cannot in any way be played down or ignored according to some experts (Qattan, 2003).

(iii) The transparency of *fatwa*

It could be argued that most of the investors in the Islamic *sukuk* market trust the *sukuk* product when there is an involvement of SSB. In this regard, the existence of the *Shari'ah* committee in most cases seems to be enough to win the hearts and minds of investors to join the *sukuk* market (Alkholayfi, 2003). Nonetheless, it can be said that the main risk is that most of the investors are not quite aware of the methods through which *sukuk* have been approved in terms of *Shari'ah* principles (Siswantoro, 2013). Thus, some investors might have some reservations regarding *fatwa* on which the scholars involved have made their *fatwa* to approve the structure for the *sukuk*

they are own. Consequently, had the investor become aware that the structure had been approved based on specific *fatwa* or a certain school of thought he might have changed his mind and would have stopped transactions dealing in that *sukuk*. In this regard, AAOIFI (2010) suggested that IFIs should have 'Audit Committee' as the main purpose for it is that it plays a significant role to achieve the fundamental objectives of the IFIs, enhance greater transparency and disclosure in financial report and to gain the public's confidence of the IFIs regarding the application of *Shari'ah* rules and principles. Thus, lack of transparency from the side of those who approve the *sukuk* poses a risk, and that the possibility that one of the *sukuk* holders could claim against the issuers for deception or ignorance should not be ruled out (DeLorenzo, 2006; Casper, 2012). In this regard, investors in *sukuk* have got the right to know the legal evidence for the validity of those *sukuk* in terms of *Shari'ah* law. In addition, investors need to know the juristic justification for such kind of *sukuk* prior to their investment on them as this is considered as a basic rights for *sukuk* holders(Van Wijnbergen and Zaheer, 2013).Therefore, issuing *fatwa* is an essential matter when it comes to the validity of the *sukuk* as well as the consequent risks might occur. In this respect, AAOIFI standards as the Islamic *Fiqh* Academy suggested that it is highly recommended to issue a written *fatwa* with related evidences and justifications as well as the distribution of the *fatawa* between other SSB and Islamic institutions will be beneficial.

5.3 EMPIRICAL ANALYSIS ON THE SIGNIFICANCE OF SSB AND THE WAY FORWARD: THE PERSPECTIVE OF SPECIALISTS

This section aims to report and discuss the position of the interviewed participants whether *Shari'ah* scholars, academics, judges or experts to explore and discover the significance of the *Shari'ah* boards in the *sukuk* market through their understanding, knowledge and experience so that the potential risk areas can better be understood and related.

As mentioned before, *sukuk* are considered as the most recent Islamic finance products which implies that *sukuk* structures and operations are in urgent need of further scrutiny and examination for the extent of compliance with *Shari'ah* rules and principles as well as the legal standards such as AAOIFI, especially after what *Sheikh*

Usmani pointed out that most of the *sukuk* issued in the market are not in accordance of the rules of *Shari'ah*.

The purpose of discussing these questions through a range of important issues related to *sukuk* is to explore and examine some of the risks that may be associated with *sukuk* in the Saudi market. The discussion is developed through the analysis of the opinions of the selected interviewees and suggestions they deem to develop the work of these legal entities as well as trying to avoid or reduce the risks that *sukuk* might be exposed in the Saudi market. In doing so, the discussion is presented in a thematic manner in the following sections.

5.3.1 Questioning the Importance of the *Shari'ah* Supervisory Boards

In questioning the importance of the SSB, interviewee 1 pointed out that Islamic financial institutions' operations are guided by the principles and values based on *Shari'ah* law which make them unique in comparison to the conventional banks. To ensure *Shari'ah* compliance on the operations of the banks and institutions, each bank and institution is required to establish a *Shari'ah* board However, as stated by the interviewee 1, in practice some of the Islamic banks, deliberately or otherwise, become involved in transactions as well as products such as *sukuk* that are sometimes inconsistent with *Shari'ah* law. It could be argued that such inconsistency could be due to a number of reasons including the role of *Shari'ah* board as suggested by one of the interviewee 2:"The failure of the SSB within those banks to live up to their duties regarding the supervision of the banking and financial transactions or otherwise failure of the bank to establish its own SSB in the first place".

According to Interviewee 2, the existence of SSB within Islamic banks and financial institutions should be considered an indispensable requirement to ensure that all products such as *sukuk* are based on *Shari'ah* principles. For that reason, some Muslim countries such as Malaysia have made the existence of SSB within Islamic banks as a basic condition to ensure *Shari'ah* compliancy, which, as argued by Interviewee 2, has reassured *sukuk* investors to do business with those banks with full trust. In this regard, Interviewee 2 also mentioned that since in Saudi Arabia, even though the state constitution refers to *Qur'an* and *Sunnah* as the main sources of legislation with regard to banking and financial transactions, and that all banking transactions which do not comply with those two sources are unlawful; the existence

of SSB to monitor *sukuk* transactions is not a condition for approving any *sukuk* structure in Saudi Arabian *sukuk* market. That is for the simple reason as stated by the Interviewee 2 that 'the policy makers in Saudi Arabian *sukuk* market assume that there is no need for such SSB as long as all banks transaction should be based on *Shari'ah* principles and operate accordingly'.

In this respect, Interviewee 3 argued that the absence of SSB, particularly in Saudi Arabia could be a risk that should be accounted for. In other words, he mentioned that the main risk is that the absence of SSB could be a threat to *sukuk* investors who unlikely to have any background on matters related to Islamic finance particularly new products such as *sukuk,* which have become widespread in the world especially in Saudi Arabia. This lack of awareness should make some Muslim investors hesitant, worried and indecisive regarding investment in those banks and financial institutions in which *Shari'ah* boards are non-existent, as they would not be able to appreciate the product as to its compliancy with *Shari'ah* law (Interviewee, 3). Thus, the only option for such investors is to avoid investment in those banks which may have negative effect on the economy.

Nonetheless, according to Interviewee 4:

> The absence of *Shari'ah* boards within banks should not be the only problem when we see some Islamic financial products such as *sukuk* are not *Shari'ah* compliant in some cases. The problem is that the lack of system that features those boards within banks in terms of aims, function, the criteria of members and the mechanism by which those board work issue their *Shari'ah*-based decision regards the products and financial processes to persuade investors in *sukuk*.

Furthermore, according to Interviewee 5, the main risks which face Islamic banking is that many governments particularly in Saudi Arabia have failed, so far, to understand the real importance of the SSB to maintain the *Shari'ah* compliancy of *sukuk* structures. Interviewee 5, therefore, pointed out that the solution to maintain *sukuk* structures to be *Shari'ah* compliant becomes simple by 'drafting the right legislations and by installing the good systems or at least activating the current practices such as AAOIFI standards'. In addition, he pointed out that those standards and recommendations could be applied to many Islamic financial organisations; and such

an application will ensure that those organisations are operating the *sukuk* transactions according to the principles of *Shari'ah*.

In further exploring the issues, Interviewee 4 asserted that the existence of the SSB within the banks and other Islamic financial organisations will play an essential role for the development of those Islamic institutions in terms of products consistent with *Shari'ah* principles by responding to the demands of investors, not to mention their positive impact on the *sukuk* market especially as a new Islamic financial product.

5.3.2 Questioning the advantages of having SSB

All interviewees were requested to give their perceptions and comments on specific issues raised by the researcher to highlight the importance of SSB towards the *sukuk* market as well as *sukuk* investors in Saudi Arabia. Based on their opinions, perceptions and understandings, the advantages of having SSB in the Islamic capital markets are as follows;

(i) Guarantee

In essentialising the importance of guarantee, Interviewee 4 argued that the existence of the SSB within the financial organisations dealing with *sukuk* will ensure that those organisations would not become involved in unlawful transactions such as the guarantee of the capital and returns in *sukuk* structures. In this respect, Interviewee 2 stated that the *sukuk* structures should be closely scrutinised and examined in terms of *Shari'ah* as to be judged by the SSB to ensure that the product or funding process in question is consistent with *Shari'ah* principles. According to Interviewee 1,the existence of such SSB should reassure every investor in *sukuk* that the money he would put in the bank for investing in *sukuk* would be invested in accordance with *Shari'ah* principles. In this respect, all Interviewees argued that

> The existence of those SSB would be meaningless unless they undertake their real role as stipulated by standards of AAOIFI featuring monitoring, follow up, reviewing and reporting the structures of the *sukuk* and the consistency of those structures with *Shari'ah* principles.

Therefore, it becomes clear that the establishment of *Shari'ah* board within every Islamic financial institution will have a great impact regarding the security of all transactions to be in accordance with *Shari'ah* principles. However, any negligence

from the *Shari'ah* boards in their duties with regard to structuring *sukuk* will have a negative impact on the *sukuk* that might become inconsistent with the rules of *Shari'ah*.

(ii) Trust

Interviewee 3 suggested that the Saudi society can be described as a 'religious society', which has impact on banking patronage. To give an example, Interviewee 3stated that Alrajihi Bank is considered as the most popular bank in Saudi Arabia joined by many of the *Shari'ah* scholars as the bank has publicly announced its compliance with the *Shari'ah* principles, and that all its transactions are interest-free. That announcement had made the *Shari'ah* scholars at that time make their judgment in favour of the bank by encouraging people to put their moneys in that bank with an understanding to avoid any dealings with other banks. Therefore, the bank has taken advantage of that judgment to win the trust of the people and as a result of that many Saudi people has involved in Alrajihi Bank and it became the top ranking bank in Saudi Arabia and the Gulf in terms of *Shari'ah* compliant assets as well as in the Gulf region. It could be maintained that the existence of the SSB within the banking establishment tends to promote trust and reassurance among investors, as stated by the Interviewee 1.As strongly emphasised by Interviewee 2, 'trust is an essential element as *sukuk* investors for instance are always looking for rules and legislation that prevent their money from being squandered and preserve their financial rights to the effect of using their money in a way consistent with *Shari'ah* principles'.

Moreover, Interviewee 4 maintained that the failure to provide that guarantee featuring the absence of SSB tends to place the money to be invested in *sukuk* transactions at the risk of loss. According to Interviewee 5, therefore, some of the banks in Saudi Arabia tend to create unreal SSB to win the trust of *sukuk* investors. Interviewee 4 also emphasised that such practice is currently going on in some of the non-Muslim countries to open Islamic windows in their conventional banks or otherwise promote products mimicking Islamic products. Such practices from non-Muslim countries, he stated, should not be taken for granted that Islamic banking provide the solution to save the world from its financial crisis. However, their aim, as Interviewee 4 stated, might be just to attract capital from Muslim countries to be invested in one of the Islamic products such as *sukuk* under the umbrella of *Shari'ah*

principles or otherwise make use of the savings of the Muslim people who are in those countries.

According to the above, it becomes obvious that investors in financial markets in general and in the Saudi market in particular are mainly concerned with the existence of *Shari'ah* boards in banks and other Islamic financial institutions. However, the existence of such *Shari'ah* boards as indicated by one of the interviewees would tend to enforce the trust of investors on Islamic products in general and on *sukuk* in particular. Therefore, having such committees will have a positive effect leading to the flourishing of *sukuk* market.

(iii) Avoidance of loss of the capital

Making profit and avoidance of loss in *sukuk* for instance are the main aim of investors in any bank or institution. In this regard, Interviewee 1 argued that risk and the possibility of loss should be taken into account in any potential business transaction, and that should differentiate Islamic transactions from other transactions, as according to *Shari'ah* principles insuring capital in any financial transaction renders the financial process an act of *riba.* Nonetheless, as Interviewee 3 asserted that 'it becomes a duty for *Shari'ah* boards to do their best to avoid any type of risks involving *sukuk* particularly *Shari'ah* risks'.

In substantiating this, Interviewee 2 referred to the fact that the real loss takes place when the *sukuk* investor discovers that he has become involved in business that does not comply with *Shari'ah* principles. According to the principal of *Shari'ah* in such case the investor has to pull out of the deal by any means no matter the consequences and eventually, he could end losing his capital. Interviewee 2, therefore, noted that, for example, after the announcement by one of the members of the *Shari'ah* board who approved the Bahrain Airport *sukuk* by saying that these *sukuk* are not *Shari'ah* compliant due to some *Shari'ah* issues people got confused. However, Interviewee 4madea question based comment with regard to the Airlines Bahrain *sukuk*: 'Who is the responsible for the loss of the capital of investors in the case of Bahrain Airport *sukuk*?' He went on to state that investors in the above mentioned *sukuk* had two options either to sell those *sukuk*, which became not *Shari'ah* complaint, at a cost less than the nominal cost which would mean loss or continue investing in those *sukuk*

which would mean becoming involved in business practice against the principles of *Shari'ah*. In addition, Interviewee 4 also pointed out that the same scenario happened following statement issued by *Mufti* Taqi Usmani labelling 85% of the *sukuk* as non-*Shari'ah* compliant. That statement had the power of *fatwa*, and eventually had negative impact on *sukuk* market. However, according to Interviewee 4 the risk of loss could be avoided if there is;

> an establishment of *Shari'ah* board that would examine the *sukuk* structure in terms of its compliance with *Shari'ah*, and the possibility of application without the risk of deviation from the right destination in accordance with *Shari'ah* principles as the case with *sukuk* from initial issuance to the end of the duration as prescribed by the issuance prospectus.

It should be noticed that any Islamic transactions including *sukuk* could be subject to profit and loss. However, the loss should not be due to the lack of performance of SSB's in undertaking their duties or due to the poor understanding of the *Shari'ah* boards towards *sukuk* structures. If this is the case, then such loss which is as a result of the shortening from the SSB's should not be justified and would have an impact on the Islamic financial reputation in general and *sukuk* in particular.

(iv) Avoidance falling into sin

Islamic financial transactions should comply with *Shari'ah* principles so that dealing and acting against *Shari'ah* law would mean that a Muslim has committed a sinful act (*haram*), which is prohibited that would make him/her subject to punishment by God in the hereafter (Interviewee, 2).In this context, Interviewee 5 argued that 'the failure in *sukuk* structures to be complied with *Shari'ah* principles and dealing in *riba* is the main cause of the *sukuk* crises in 2008'. He further asserted that dealing with *riba* transaction is the source of financial crisis that beset the USA financial markets (Interviewee, 5). Having said that, *riba* has many forms in these days and could even be confusing for scholars not to mention lay people who have no background in *Shari'ah*-related matters (Interviewee, 1). In this respect, Interviewee 4 stressed the fact that;

> The absence of the specialised *Shari'ah* boards in *sukuk* that give advice to people as to distinguish between which *sukuk* structures are allowed and which are forbidden, has been the main cause for the financial

> malpractices that have made people become involved in sinful financial transactions.

In ensuring the prohibition of *riba*, Interviewee 3 pointed out that the local banks in Saudi Arabia are monitored by the Capital Market Authority (CMA), which bans banks and other financial organisations from becoming involved in any financial transactions that do not comply with *Shari'ah* principles. According to Interviewee5, the problem is that investors in the Saudi *sukuk* market believe that all *sukuk* in Saudi Arabia are *Shari'ah* compliant, therefore, they do not care whether SSB and their decisions in relation to those *sukuk* are exist or not. For that reason, Interviewee 5 made it clear that;

> The problem should not be the absence of SSB but rather raising people's awareness of the main problems and risks regarding the application of the Islamic financial system within those Islamic financial institutions, and the fact that some of those banks and organisations operate out of the control of *Shari'ah* system.

Therefore, it could be argued that any failure or negligence that could take place from SSB's regarding the examining of *sukuk* structures could cause great embarrassment to investors. In other words, Muslim investors either continue sinful acts due to becoming involved in non-Islamic transactions or lose their capital. That should make SSB's do their best while they approving any structures to avoid sinful acts that might be practiced by investors in case they discovered the product had been inconsistent with *Shari'ah* principles.

(v) The invention and development of products in compliance with *Shari'ah* principles

Interviewee 1 mentioned that in relation to managing risks involving the Islamic finance products in general and *sukuk* in particular, the dilemma is that the majority of the staff in Islamic banks has previous experience in relation to conventional banking. That experience in conventional banking has negative impact regarding devising the necessary tools in relation to Islamic financing and investment including *sukuk*, which, according to the Interviewee 1, to a great extent has converged towards conventional financial transactions. In this context, Interviewee 4 referred to this particular problem as the real problem of IBF by stating that;

> the dogmatic state and the underdevelopment of the Islamic banking system with regard to the *sukuk* instructions and the mechanism of

> operation could be due to the lack of the qualified personnel within the Islamic banks and organisations with the know-how in *Shari'ah*-related matters that make them capable of innovation to the effect of generating new products in compliance with *Shari'ah* principles, or otherwise readjusting conventional products in compliance with *Shari'ah* principles.

In confirming this, Interviewee 2 pointed out that the existence of *Shari'ah* boards alone is not enough with regard to the invention and development of *Shari'ah* compliant products as it is obvious that despite that many banks and Islamic organisations have SSB, and yet Islamic banks are short of *Shari'ah* compliant products. It should be noted that the same comments were uttered also by Interviewee3 who maintained that 'the majority of *sukuk* in the *sukuk* market feature *ijarah* which considered by some critics as one of contracts that should be examined and evaluated'.

For that reason, Interviewee 5 is of the view that development of *Shari'ah*-compliant products should require that the *Shari'ah* board in each financial institution should accommodate law specialists, financiers, and accountants who should work side by side each in his own field in order to create a product in response to the needs of the society in ensuring *Shari'ah* compliancy. In the meantime, that product should be risk-free with regard to its compliance with *Shari'ah* principles. With that mechanism, Interviewee 5 argued that the Islamic banking system becomes capable of competing with the top of the range of the conventional products in international financial markets by presenting Islamic products. To be more precise, Interviewee 1 pointed out that the current financial institutions have to 'live up to the main challenge by generating products and services in accordance with *Shari'ah* standards, and in the meantime should be capable of competition with other financial products as to achieve profits in the long run'.

It becomes clear from the above that SSB's have to cope with the main challenge as to make Islamic products attractive to investors. However, in the meantime, the existence of SSB's should not be enough as to respond to the market requirements regarding the discovery and development of various new Islamic products in response to the market needs. Consequently, there is a potential necessity for financial specialists in general to employ their expertise in discovering new structures and products that are consistent with *Shari'ah* principles monitored directly by SSBs.

(vi) Ensuring the achievement of *Shari'ah* objectives (*Maqased al-Shari'ah*)

According to Interviewee 1, the aims and objectives of *Shari'ah* rules could be used as an benchmark to judge whether a specific institution is being run in accordance with *Shari'ah* principles or not. However, scholars are in full agreement of the fact that the preservation of wealth is one of the main objectives of Islamic *Shari'ah.* As a matter of fact, Interviewee 1 argued that *Shari'ah* which protects and preserves the social order must pay great attention to reserve wealth. It should be mentioned that, the following dimensions have been presented to most of the interviewees to gain their comments on how wealth can be preserved as follow;

Preservation of wealth by protecting the right of ownership

Interviewee 4 noted that Islamic law acknowledges that human being has a natural instinct for ownership, thus, defining clear standards to control this instinct in terms of usage and saving of money; and hence it does not have a particular issue and problem with wealth generation. In this regard, according to Interviewee 1, one of the main concerns of SSB is to ensure that *sukuk* investors enjoy that ownership in the context of the aims and objectives of *maqased al-Shari'ah*. In essentialising the importance of this, Interviewee 3 argued that the existence of SSB within financial organisations should ensure that one of *Shari'ah* objectives, featuring the preservation of money for its ownership, has been achieved as well as to ensure that money, no matter in form of cash or assets, or otherwise should be always available for the owner who should have full authority to decide on his belongings. In this respect, Interviewee 4 pointed out that;

> Currently, the main problem and risk that faces *sukuk* from *Shari'ah* and legal perspective is that, *sukuk* holders do not enjoy their full rights upon their *sukuk*. In other words, that ownership of their underlying assets is only nominal as the case with many *sukuk* structures.

Moreover, Interviewee 2 argued that, from *Shari'ah* perspective, the complete denial of ownership or otherwise making that ownership incomplete must be incompatible with one of *Shari'ah* objective featuring the preservation of wealth. That fact has been further confirmed by Interviewee 1 who stated that 'the preservation of wealth, by

ensuring the full transfer of *sukuk* assets from *sukuk* issuer to *sukuk* holders, should represent a genuine part of the objectives of *Shari'ah'*.

In this regard, preserving the capital as much as it could when designing *sukuk* structures is one of the main *Shari'ah* objectives. In other words, proving the ownership for the *sukuk* holders is considered one of maqased al-*Shari'ah* that should be considered.

Preserving wealth from harm

According to Interviewee 5, *Shari'ah* always calls for protection of wealth from any type of damage through two means: first, the protection of wealth from potential risks that could produce damage, and second, the prevention of damage by disallowing abuse of wealth. In this respect, Interviewee 3 suggested that the presence of SSB to monitor *sukuk* structures and put course of the *sukuk* from the time of issuance to time of expiry should an important and essential matter. Interviewee 5 also pointed out that;

> The abuse of money for purposes inconsistent with *Shari'ah* could be mainly due to the failure of SSB to live up to their real duties with regard to the continuous supervision and control of the various financial processes to be undertaken by the relevant financial organisations.

In the meantime, Interviewee 4 stated that unless the risk management of a specific investment lives up to its duties, the outcome will be disastrous in a way that threatens the economy of the region or state. Therefore, it implies that risk management is a matter of paramount importance.

Preserving money by preserving its value

According to Interviewee 2, *Shari'ah* law, among other *maqased* items, aims to preserve wealth through preserving its value. For instance, the Holly *Quran* states what could be translated as 'you should not underestimate other people's things'. The term 'underestimate' refers to low evaluation, dishonesty and deception in measurement. In this context, Interviewee 1 referred to the fact that in Saudi Arabia, some of *sukuk* structures seem to be 'fraudulent and deceptive', and therefore he argued that they are in clear contradiction with Islamic moral principles. Interviewee 1 also stated that those *sukuk* are *ribawi* designed in a complex structure for

deception. Furthermore, he maintained that '*sukuk* structures currently could be deceptive as the method of evaluation of those *sukuk* was unclear, and without the due transparency'.

According to Interviewee 3, he asserted that the real value of *sukuk* has not been taken into account from *sukuk* holders so that *sukuk* holders are not bothered whether the price they have paid for *sukuk* is fair or not, as they will sell the assets back to the main buyer in the nominal value and they will have their money back without any loss. Therefore, Interviewee 1 argued that;

> Many *sukuk* structures had indirectly guaranteed the capital as well as the return so that the *sukuk* holders would not bother about the evaluation of the *sukuk* assets at the time of purchase whether it was based on real and fair evaluation or fraudulent and deceptive evaluation.

Nonetheless, Interviewee 2 pointed out that the real risk comes if those *sukuk* go bankrupt, in which case failure to meet the objective of preserving the fair value of money becomes obvious.

In addition, Interviewee 4 maintained that understanding the *maqased al-Shari'ah* should imply that the financial institutions should be controlled according to the moral and legal principles of *Shari'ah,* which could be through defining the transactions to be undertaken by those institutions within the moral framework to be outlined by *Shari'ah*. For instance, Interviewee 4 stated that *Shari'ah* tends to preserve individual rights of ownership, and yet those rights are subject to specific rules and moral standards that have been drafted to protect social rights. Thus, Interviewee 5 noticed that Islamic financial institutions are not expected to operate in isolation of the society, as its main task is to achieve balance between the individuals and the society in terms of rights and duties.

From the above discussion, it becomes obvious that observing *maqased Al-shari'ah* in Islamic financial products in general and *sukuk* structures particularly is one of the main issues when it comes to structuring *sukuk*. In this regard, SBSS has a duty to make sure that the *maqased Al-shari'ah* have to be taken into account during the approval of *sukuk* structures.

(vii) Education and training of staff and exchange of knowledge and experiences

According to Interviewee 1, it becomes obvious that the majority of the staff in Islamic banks and Islamic financial institutions have come from a background that could be linked to conventional banking, and that has indirectly affected the *sukuk* issued by Islamic banks and other financial institutions. Thus, according to Interviewee 2 'the existence of SSB should be vital for Islamic organisations in terms of providing the necessary training for the staff to develop the Islamic products particularly *sukuk* which is considered relatively new in the Islamic financial markets'. By contrast, Interviewee 4 stressed the fact that the mere existence of SSB is not enough unless those SSB keep close sustainable relationships with the staff in the relevant organisation. Those relationships could be beneficial by raising awareness of *Shari'ah* rules among the staff members through lectures and training sessions to be provided by the members of the *Shari'ah* boards in order to raise awareness with matters related to Islamic contracts, and the modern methods of financing such as *sukuk* as well as highlighting the risks associated with those methods. Moreover, Interviewee3 suggested that the task of examining the products for approval should not be confined to the SSB alone but the board should seek the advice of the relevant departments to clear legal and accounting matters and in effect issue clear products in compliance with *Shari'ah,* financial and legal matters. On the other hand, Interviewee5 noted that members of staff in Islamic financial institutions have very poor knowledge and awareness of *Shari'ah*, and that matter, so far, has not been addressed by the SSB who have failed to undertake their role in raising knowledge and awareness of *Shari'ah*-related matters among the staff.

5.3.3 Questioning the Concept of *Shari'ah* Board

In exploring the position of the participants on *Shari'ah* board which is essentially important for the success of any *sukuk*, Interviewee 1 mentioned that it becomes of paramount importance to give a comprehensive definition for SSB within financial institutions not matter those institutions being Islamic institutions or otherwise, as people and particularly the members of those boards must become aware of their duties and commitments when they approve any *sukuk* structures'. In referring to the definitional issues, Interviewee 2 noted that AAOIFI has defined the SSB as

consisting of members with an expertise in the field of *fiqh*. However, he argued that this definition has been cause of the problem with regard to the failure of the boards to undertake their duties while approving *sukuk* structures, as the above definition is inadequate falling short of highlighting the real duties of the board members. In identifying the importance of such a definition, Interviewee 4 stated that by giving an accurate definition of the SSB, the members of the board can be held to account for underperformance.

As part of the conceptual definitional issues in particular in responding to the nature and composition of SSB, interviewee 3argued that it is not necessary that the SSB should incorporate expertise from other fields as the duty of those boards is confined to the approval of the *sukuk* structures or otherwise refer that structure back to the bank with the appropriate comments. In substantiating this, Interviewee 4 maintained that 'the problems with *sukuk* in Saudi Arabia in terms of *Shari'ah* issues have been due to the fact that *Shari'ah* boards within the relevant banks lack the awareness with regard to the structuring of *sukuk'*. In addition, Interviewee 4 asserted that most SSB members have no idea with regard to the legal and financial complexities that might render *sukuk* inconsistent with *Shari'ah* principles as those boards deal with *sukuk* without the appropriate expertise in the legal and financial matters. However, Interviewee 1 argued that until now a comprehensive definition of SSB has yet to be found, and organisations such as AAOIFI and Islamic Financial Services Board (IFSB) have a duty to find a comprehensive definition as to allow the appointment of SSB according to recognised international standards as suggested.

5.3.4 Questioning the Purpose of *Shari'ah* Boards

As regards to the purpose of SSB, Interviewee 1 pointed out that defining the objective and aim of the SSB is a matter of paramount importance. He argued that the current chaos and confusion within Islamic financial institutions including banks, particularly with regard to the *Shari'ah* compliancy of *sukuk*, should make the aims and objectives in relation to SSB questionable. In this regard, Interviewee 2 pointed out that 'the aim and purpose of those SSB are still vague and unclear as to whether it relates to just the approval of *sukuk* structures and their consistency with *Shari'ah* principles or the control and continuous scrutiny of the products to verify their consistency with *Shari'ah* standards'.

According to Interviewee 4, some of the banks choose their SSB to approve their *sukuk* for the purpose of business without considering to *Shari'ah* and legal risks which might face *sukuk* in the future. This is what El-Gamal refers to '*fatwa* shopping and *Shari'ah* arbitrage'. In addition, Interviewee 4 noted that 'some of the financial organisations do not pay much attention to the spirit of *Shari'ah* and its objectives when they invest in *sukuk*, but rather focus on profit making'.

In exploring the 'fictitious rather than the main aim' of the SSBs, Interviewee 5 stated that the main aim of SSB in some of the financial institutions is to attract investors by deceptive means to invest in *sukuk* by labelling them as being *Shari'ah* compliant. Moreover, according to Interviewee 3, the concept and aim of *Shari'ah* board should be made clear through AAOIFI standards and other authentic organisations as well as it should be implemented accordingly.

5.3.5 Questioning the Function of the *Shari'ah* Boards in *Sukuk* Issuance

As regards to the function of the *Shari'ah* boards, all interviewees have asserted that SSB has a major role upon *sukuk* market. In this regard, Interviewee 1 stressed the essential nature of the *Shari'ah* board in articulating that 'In Saudi Arabia, most risks in relation to *sukuk* structures in terms of *Shari'ah* could be due to the failure of SSB to undertake their duties featuring review, close examination and control of the structures as required from them'. However, Interviewee 4 added that in most cases the exact duties of the members of the *Shari'ah* boards are not clear as those duties vary from one bank to another. Interviewee 2 highlighted that in most cases, the only duty of the most of the members of SSB is to approve that the structure is *Shari'ah* compliant.

Interviewee3, on the other hand, suggested that before discussing the duties to be undertaken by SSB, one has to make sure that those boards have access to information from the relevant financial institution as well as any information associated with the *sukuk* to be examined for approved. In addition, he mentioned that AAOIFI has set some of the procedures required to be followed by SSB in relation to the product to be approved such as SSB should have access to all documents, records and information featuring the product under scrutiny.

In this regard, Interviewee 5 pointed out that easy access to the required information is a necessary matter for the SSB to issue their judgment on any *sukuk* as one of the *Shari'ah* rules states that 'judging on something is part of its conception'. In other words, the *Shari'ah* scholar cannot issue any verdict as to whether a certain product is *Shari'ah* compliant or not before making a clear view of the nature of that product from all aspects (Interviewee, 5). Thus, the Interviewee 2 suggested that the member of SSB has the right of access to all the relevant documents, and also the SSB members should have an excellent communication with all parties associated with the product under scrutiny such as accountants, legal experts and others. However, Interviewee 4, in a critical manner, stated that the main risks associated with Islamic financial products, particularly *sukuk* is that, the members of SSB have no access to all the relevant documents.

In this regard, Interviewee 3 suggested that SSB should have a duty to review all documents in relation to the *sukuk* in question following any potential modification to be made by the SSB. Thus, as identified by the Interviewee 1, the SSB has the duty to stop signing any product for approval before closely re-examining the contract after the proposed amendment to ensure that the contract is free of errors in violation of *Shari'ah* principles that might cause risks to both the investor and the financial organisation that has produced the product as well as the economy of the state in general.

Furthermore, Interviewee 1 mentioned that the members of the SSB should be fully aware with the production process and the course of development of the *sukuk* structure featuring the legal, financial and managerial aspects. In substantiating this, Interviewee 2 stated that 'otherwise legal and *Shari'ah* risks will be faced. For instance, in case of disputes or in case the issuer goes bankrupt how the *sukuk* holders going to prove their rights of the assets?

In terms of consequences of a proper process, Interviewee 5 highlighted that the full awareness and understanding of the members of SSB of *sukuk* structure should favour *sukuk* holders in terms of the potential risks with regard to *Shari'ah* principles.

5.3.6 Questioning the Rule of *Fatwa*

This section discusses the rule of *fatwa* in the process of issuing *sukuk* through the analysis of the interviews.

5.3.6.1 The steps of issuing the judgment on the *sukuk* structures (*fatwa*)

As regards to the steps involved in issuing a *fatwa* on the *sukuk* structure, according to the Interviewee 1, the approval of *sukuk* by SSB should feature a number of steps to guarantee the validity of the product in terms of *Shari'ah* principles. However, Interviewee 2 stated that many of the prospectuses of *sukuk* have stopped short of explaining the mechanism of approval of *sukuk* in terms of *Shari'ah*. As, the prospectus only explains that the *sukuk* structure has been examined by the relevant SSB and has been approved in terms of *Shari'ah* rules without mentioning the steps involved in the procedure(Interviewee 2).Therefore, Interviewee 1 asked the existential question as to 'whether the *sukuk* have been drafted, structured and produced in its current form by the SSB or otherwise the role of the SSB is only limited to the approval of the *sukuk*?', which will remain an important debate in Islamic finance industry.

In providing a sceptical view, Interviewee 4, therefore, argued that 'the function of SSB seems to be only limited to approval the validity of the structure and has nothing to do with any details prior to that'. In addition, he stated that it seems that the *sukuk* have been structured without consultation with the SSB, as the role of the SSB is relegated to proposing the suitable readjustment of the product for *Shari'ah* compliancy. Furthermore, Interviewee 3 confirmed that in terms of *Shari'ah* side, one of the risks associated with *sukuk* structure is the fact that 'the drafting and structuring of *sukuk* is made by individuals who are disqualified in *Shari'ah* terms, whose background is related to traditional products, so that the *sukuk* comes out almost identical to interest-based (*riba*) *sukuk*', as the SSB involves in the very last stage of the process.

For that reason, Interviewee 3 suggested that the banks have a duty to establish a special department for *Shari'ah*-based investigation and scrutiny as those departments should include specialists and scholars in the doctrine of *fiqh* featuring Islamic transactions, economics, law and accounting, and should have the basic knowledge of

Shari'ah. As identified by the Interviewee 3, those departments should take part in 'the drafting of *sukuk* related contracts as well as other *Shari'ah* products before the *sukuk* contract is presented to the SSB. The process of *sukuk* issuance by such a department should follow a comprehensive process, which must refer to financial, economic and legal underlying elements of *sukuk* besides the elements of *Shari'ah*. Such a process will ensure that *sukuk* will be secured from any anti-*Shari'ah* malpractice'.

Furthermore, Interviewee 2 suggested that there is a need to have specific and clearly written steps for the development of the product from its preliminary drafting to the end when the *sukuk* expire, and that those steps need to be approved by recognised organisations such as AAOIFI. Moreover, those arrangements should become a mandatory practice for Islamic financial institutions including banks in association with the offering of *sukuk* to investors (Interviewee 2).

5.3.6.2 *Shari'ah* board in relation to changing their *fatwa*

An important issue in the *sukuk* issuance process is the possibility for the SSB to change their fatwa. In exploring thus, Interviewee 1stated that one of the risks featuring *sukuk* in relation to SSB is reconsidering the *fatwa* issued for the approved *sukuk* by the SSB itself or in the case one or more than one members of the SSB changes his mind. In exploring such a matter, Interviewee 3pointed out that changing *fatwa* from the SSB whether one of them or more could be for a number of reasons. Most importantly, the member might realise that he was not aware of some facts at the time judgment had been made on the product (Interviewee, 3). Thus, Interviewee 5 suggested that changing *fatwa* could be made by speeding up the judgment without taking sufficient time to examine the structure fully and comprehensively so that the members can make their judgment on the *sukuk* without the risk of making errors. However, Interviewee 2 mentioned that the error in *fatwa* can possibly happen, but it is incumbent on the member to issue a written statement explaining the error he has committed, and the right formulation of the *sukuk* that *Shari'ah* compliant. Interviewee2 is of the opinion that the *sukuk* holder even if he realises that the *sukuk* with which he is involved is not *Shari'ah* compliant, he can continue to invest in the *sukuk* he hold until the contract expires, as he considers the *sukuk* valid based on *the fatwa* issued by a *Shari'ah* scholar at the time of issuing in which case he should not

get rid of the *sukuk*. On the other hand, Interviewee 4 stressed the point that the *SSB* should become aware of its role and live up to its responsibilities, and that any errors in its judgment on the product will have adverse impact on the economy in general and on the investors on the *sukuk* in particular.

5.3.7 Questioning Specific Issues Related to the *Shari'ah* Board Members

This section aims to present the analysis through the contribution of the interviewee's arguments and statement in relation to the issues related to SSB members.

5.3.7.1 Questioning the qualifications and criteria of the SSB members

Interviewee 3 pointed out that every Islamic institution including banks sets its own standards and criteria for choosing its SSB members, and yet those standards and criteria are not known to the general public. In addition, Interviewee 3described the absence of criteria and standards recognised by supreme Islamic organisations as being unfortunate. Interviewee 1 also referred to the fact that members of the SSB in banks who approve *sukuk* structures need to be retrained to be qualified to face the new structures designed from those who came from conventional side. In this regard Interviewee 4suggested that

> The member of the SSB should not be understood as a mere *sheikh* according to his *Shari'ah* background (in the sales background), but rather as an expert in Islamic banking and finance. Nonetheless, such expert should have the knowledge of *Shari'ah* in relation to the rules of buying and selling, and also in economics and finances, besides successfully attending training sessions in the basic principles of accounting, finances and law.

In further exploring, Interviewee 4 added that it is not a difficult task to recruit such type of people to become members of the boards, as they could be considered more of an expertise in IBF rather than *Shari'ah* scholars. This view point is supported by Interviewee 1 who suggested that a distinction should be made between a *fatwa* in which the error is confined to the person who asked the question and the approval of an Islamic product in which case any error of judgment in *Shari'ah* terms could have damaging consequences on the state of economy in general and the reputation of IBF as well. This point of view is further explained by the Interviewee 1, who asserted that in many occasions the *fatwa* is only related to the question of the person seeking *fatwa*, while the judgment on the product such as *sukuk* as to its consistency with

Shari'ah principles implies that the member of the board should be knowledgeable in many fields, such as finance, economics, accounting, and law to be able to provide an effective and efficient opinion, otherwise that could negatively affect his judgment on the product.

On the other hand, Interviewee 1stated that some famous *Shari'ah* scholars in the IBF sector of the Saudi Arabia sit on the SSB of more than one bank. That should indicate a shortage in expertise with regard to IBF, or otherwise the standards set by the various banks are so difficult that only a few persons can be qualified to become members of SSB. In this respect, Interviewee 4noted that 'banks always look for famous *sheikh* no matter the level of their knowledge of *Shari'ah*, while others look for *sheikh* with moderate rather than conservative attitudes regarding their *fatwa* related to financial matters'.

Interviewee 2, therefore, critically noted that most of the Islamic products in Saudi Arabia carry the signature of certain *sheikhs*, and the main reason for this is not the shortage of expertise in the field of IBF, but rather due to the fact that the relevant banks prefer not to employ other *sheikhs* who might not comply with the policies of the bank with regard to the promotion of its products such as *sukuk*.

In providing a critical and macro perspectives, Interviewee 5 noted that CMA which is designated for the organisation of the Saudi market has not set any standards or criteria in relation to the qualifications expected of the SSB members, leaving the whole matter to the bank administration to nominate and select the members.

5.3.7.2 Questioning the relationship between the SSB and other related authority

According to Interviewee 1, the main duty of SSB is to verify the product as being *Shari'ah* complaint and with these boards functioning in a proper manner, the rights of *sukuk* holders will be secured.Interviewee4pointed out that the main risk involving *sukuk* is that

> The judges of the *Shari'ah* courts as well as the committee members who are responsible for the financial securities problems in Saudi financial market have no commitment to take into account the *fatwa* approved from SSB even though if they stated that such structure is compliance with *Shari'ah* rule.

Interviewee4 further explained such a risk by stating that in case of any problem, the *sukuk* holders will eventually be referred to either *Shari'ah* courts or committees who are responsible for the financial securities problems to get their rights, but the judges might nullify the *sukuk* contract due to some inconsistencies with *Shari'ah* principles without recognising the signatures of the SSB that has approved that particular *sukuk*.

In further reflecting on the rationale for the SSB, Interviewee 3 questioned the wisdom of establishing SSB in banks while the judgments they issue are not recognised by *Shari'ah* courts as well as CMA. Therefore, Interviewee 5 shifted the debate to the importance of central *Shari'ah* board as a government body. The main duty of the central boards is the approval of *sukuk* issued by banks, and that decision made by those boards should be taken into account by all parties involved, so that in case of any dispute, the judges of the court of law have to nullify the *sukuk* contract due to some inconsistencies with *Shari'ah*, as long as that *sukuk* has been approved by the central board. As identified by the Interviewee 5, such an arrangement will secure the rights of *sukuk* holders on the assets that belong to them, which favours stability of the Islamic financial markets.

5.3.7.3 Questioning the application of AAOIFI standards by the SSBs

Since AAOIFI is established to provide standards for the IF industry, it is expected that Islamic banks and financial institutions should also consider such standards in relation to *sukuk* issuances. Interviewee 2, therefore, noted that AAOIFI has issued specific standards featuring *Shari'ah* contracts to be as a guideline for SSB. He also stated that 'those standards represent a step forward to keep the *sukuk* contracts within the framework of *Shari'ah* as not to resemble interest-based (*riba*-based) bonds'.

In the respect, Interviewee3 stated that availability of standards such as those of AAOIFI should be considered a pioneer step in the field of Islamic financing, and yet those standards will not worthwhile and will be ineffective unless their implementation is made mandatory by the SSBs upon their drafting of *sukuk* structures.

In providing a critical perspective, Interviewee 1 pointed out that among the reasons that make some of the members of the SSBs become adamant to implement AAOIFI standards or otherwise consider the standards as unbinding is that commitment to

specific standards closes the door of interpretation(*ijtihad*) in relation to *fiqh* and the commitment to specific standards also make the *ijtihad* of the members meaningless as long as they rely on prejudged opinions in the form of standards, and that his only role becomes focused on linking the already made judgment with the case in point.

In considering potential solutions, Interviewee5 mentioned that currently, many people in Saudi Arabia can for implementation of a measure known as 'the legalisation of *Shari'ah*-based judgments'. Such legalisation has the following advantages according to Interviewee5; first, it provides a reference for all staff featuring IBF not to mention investors with no *Shari'ah* background in relation to such products particularly new one such as *sukuk*. Secondly, *Shari'ah*-based judgments in that law will be accurate and more detailed as to become more worthwhile than AAOIFI standards as it seems to be generalised needing more detailed explanation as well as redrafting as to become clear. Thirdly, among the benefits of legalising *Shari'ah*-based judgments involving financial transactions according to Interviewee 5 is that such law will minimise the disagreement between *Shari'ah* scholars with regard to *fatwa* involving financial transactions. Furthermore, he stated that such law tends to have positive impact as to protect the rights of *sukuk* holders from being squandered.

5.3.7.4 Questioning the accountability of the SSB members

Since the Islamic financial markets and operations have been expanding in Saudi Arabia, Interviewee 5 pointed out that 'the scholars who show interest in issues related to Islamic financing have recently become in high demand'. However, as discussed above, their qualifications are an issue which may lead to reputation and *Shari'ah* risks. All Interviewees, therefore, have asserted that the *fatawa* issued by any SSB need to be carefully thought to avoid any potential risk associated with the methods of Islamic financing. This implies that with the increased demand for and available opportunities for new Shari'ah scholars, not well educated and trained individual scholars joining the ranks may cause for the emergence of certain risks.

Interviewee 2 stated, therefore, that the high demand could be linked to the general tendency of investors to set a condition that there should be a *Shari'ah* board. For that reason, many Islamic banks and other financial institutions have managed to establish *Shari'ah* boards in order to boost their products in the markets through giving them

the necessary cover in terms of *Shari'ah* tinge (Interviewee, 2).In substantiating this, Interviewee 3 mentioned that:

> The increasing demand for scholars has negative impact on the quality of the SSB as the Islamic banks and institutions have recruited individuals who are not knowledgeable enough in *Shari'ah* terms to deal with and approve new products, and in the meantime that has put more pressure on the scholars with good reputation in the area of IBF.

In further exploring the risks related to *sukuk* and *sukuk* issuance, Interviewee 5 noted that the risks involved in structuring *sukuk* could be the existence of two types of *Shari'ah* scholars. The first type features those who have good reputation in terms of their knowledge of *Shari'ah*, however, the fact that those scholars are members of many *Shari'ah* boards has weakened their performance making the *fatawa* they make unreliable. The main problem is that those scholars are very busy so that they have no time to understand thoroughly the new products, which will eventually make them issue the wrong *fatwa* on those products. In further explaining, Interviewee 5 also refer to the another group of scholars who join the *Shari'ah* boards without having the necessary knowledge of *Shari'ah*. Their presence, Interviewee 5 argued that paves the way to the emergence of *Shari'ah* risks also, as their only legitimacy comes from the fact that they become a SSB member, which somehow qualifies them to examine Islamic financing products particularly the new products such as *sukuk*. This is considered as an essential risk and challenge in front of Islamic finance sector.

In an attempt to find a solution, Interviewee1 suggested that 'those risks could be avoided by inventing a system that would call the members of the SSB to account for the errors in relation to the *fatawa* and decisions they make'. Nonetheless, that suggestion is opposed by Interviewee3 who noted that those *fatawa* are the product of personal efforts made by the members through *ijtihad* in which case errors should not be punishable as indicated by the principle of *Shari'ah* law. On the other hand, Interviewee 2 pointed out that "it is necessary that standards and specifications to be set for the selection of those who have the right of judgment and approval of *sukuk* structures prior to calling the members of *Shari'ah* boards to account for the errors they make". On the other hand, Interviewee 4suggested that it is necessary to create what is known as "The license for *fatwa* in relation to matters associated with Islamic

financing", in which case those who SSB without being licensed should call to account.

In relation to the Saudi market, according to Interviewee1, the problem with Saudi Arabian market is that "no system is available for controlling and organising *fatwa* including the judgment of a product as to their Islamic orientation, as well as those who have the right of making such judgment". He also stated that the SSBs to a great extent have been practicing *fatwa* in a manner that has been and still being practiced in Saudi Arabia. That practice features contacting the scholar in person and asking him direct questions to which he would provide answers on the spot without closely scrutinising the question from all aspects particularly question that need one to be careful and patient. Interviewee 1, therefore, in supporting his argument continued to explaining as what has been happening with the *fatwa* practice in Islamic banks by stating that "as the product is presented to the SSB, which judges the product based on the description provided to them rather than on scientific facts based on examination and analysis with the due patience and care rather than giving a hurried judgment". Therefore, Interviewee4 stated that those who issue *fatwa* need to be well informed in *Shari'ah* matters. For instance, there must be individuals who are specialised in family affairs, and others in criminal affairs such as murder, theft *etc*. and some need to be specialised in matters associated with *sukuk* as such specialisation tends to enhance the position of those who make *fatwa* in terms of scientific knowledge (Interviewee, 4). Moreover, Interviewee 2 supported this suggestion by stating that specialisation will make it easy for the authorities to follow up their activities of the boards and call them to account for any potential errors.

5.3.7.5 Exploring the source of authority to call SSB for the accountability

Since there is a general consensus that SSB should be accountable, it is important to explore the source of such an authority to be charged with a function for SSB's accountability. For this, most of the interviewees agreed that "it should be a proper law and system for arranging the judgments and *fatwas* in relation to issues associated with Islamic finance.

This agreement should raise the question: as to who is authorised to enforce such law so that members of SSB who do not follow the law should call to account? In this regard, Interviewee 2 mentioned that in Saudi Arabia there is no Central Bank to

control such matters unlike the case with Malaysia for instance. On the other hand, Interviewee 5 believed that such role should be undertaken by CMA, which is the legal authority for organising the financial market. Interviewee 5 also noted that the CMA has given up its role with regard to controlling the integrity of Islamic products including *sukuk* in terms of *Shari'ah*. He also stated that CMA has given up this sensitive role leaving it for Islamic banks and other Islamic financial organisations without any central regulative authority.

Interviewee 4 has also essentialised the importance of a supreme central authority to control *fatwa* featuring issues in relation to Islamic financing, given the great intention of both Islamic and commercial banks to do business involving Islamic financial methods.

In addition, Interviewee5 suggested that the benefit of such independent central authority is that it makes members of SSB in banks and financial organisations feel that they are accountable for their failures regarding the implementation of the necessary procedures as well as their judgment on any product in terms of their *Shari'ah* compliancy. Consequently, as Interviewee 5 argued that will make them put the necessary efforts to study the product in question thoroughly before issuing their final verdict. Interviewee3also suggested that

> Members of SSB should morally call to account including suspension of their activities in relation to issues associated with Islamic financing provided they have proved to fail to abide with the guidelines in relation to the *fatwa* and judgment of the product as to its consistency with *Shari'ah* principles. Alternatively, the members of SSB should also financially call to account for their errors by paying fines.

5.4 THE FUNCTION OF THE SBSS REGARDING SABIC *SUKUK*: INTERVIEW DATA ANALYSIS FROM THE PERSPECTIVE OF SBSS MEMBERS

In an attempt to provide a critical understanding of the identified issues in SABIC *sukuk*, it is essential to discuss the primary data collected through interview survey from the field with SBSS. In this regard, the following sections present the analysis of interview responses from the members of the SBSS with regard to their own function as well as some critical points which have been recently raised as follow;

5.4.1 Examining the Role SBSS Played in the Process of Drafting the Structure of SABIC *Sukuk*

This section aims to present the answers gathered from the interview question which aimed at examining the role of SBSS in the issuance of SABIC *sukuk*. In this analysis, whether the SBSS has been the real player behind the structuring of *sukuk* or otherwise its role has been confined only to the process of reviewing and approval of *sukuk* is also examined.

In elaborating these issues, all members of SBSS have responded by saying that as far as SABIC *sukuk* is concerned the role of SBSS has been limited only to the process of reviewing and approval of *sukuk* structure without being involved in any way in the process of drafting the structure of *sukuk* or otherwise being engaged in any other arrangements that precede the drafting of *sukuk*. In this regard, two of the members of the SBSS pointed out that the structures of *sukuk* presented to the SBSS would usually need full restructuring due to inconsistency with *Shari'ah* principles in terms of similarity with *riba*-based bonds. Moreover, the first members of the SBSS added that the first issue of SABIC *sukuk* presented to the SBSS had greatly resembled the traditional bonds in structure in terms of the guarantee of the capital and profits, and that real and legal transformation of assets from the *sukuk* issuer to the *sukuk* holders in terms of *Shari'ah* did not exist. In addition, he said that the SBSS normally identify its comments pointing out the real problems from *Shari'ah* perspective after close examination of the *sukuk*. The *sukuk* was then referred back to the *sukuk* issuer who drafted the structure in response to the comments by making the necessary amendments in accordance with *Shari'ah* principles as it has been indicated by one of the members.

From response of the SBSS, the following conclusions can be drawn through interpretative discussion;

(i) It is clear that SABIC *sukuk* has been approved by SSB. Accordingly, the *sukuk* was allowed to circulate in the Saudi exchange market;

(ii) In addition, from the above it is obvious that as far as SABIC *sukuk* is concerned the SBSS has been concerned only with the structure and approving that structure in

terms of consistency with *Shari'ah* principles or otherwise referring it back to the *sukuk* issuer to be amended in accordance with the comments to be made by the SSB;

(iii)It is important to observe that the SBSS did not make any contribution to the drafting of SABIC *sukuk*, and has never made any preliminary arrangements involving other committees, legal persons or accountants, and yet SABIC *sukuk* structure was presented to SBSS by persons from outside the SBSS implying that the structure has not been the work or invention of the SBSS;

(iv)The forgoing account by the SBSS demonstrates that there is no clear method for the SBSS to work with, as the SBSS member interviewed failed to explain a specific approach and whether a specific method for action has been available to them to undertake their duties as SBSS. In other words, the analysis indicates that SSBs are not requested by the relevant bank or financial organisation to stick to a clear method and mechanism in their examination of Islamic financing products nor do they have a particular mechanism or structure to reach a verdict regarding the *Shari'ah* compliancy of Islamic financing contracts in the case with *sukuk*, which could make them avoiding the potential *Shari'ah* risks that could definitely have negative impact on the *sukuk* product such as SABIC *sukuk* in particular and the Islamic financing industry in general. It seems that this was the case with the SSB dealt with the SABIC structure, as arbitrariness seems to be the method of process and procedures. This should be considered as a source of worry in terms of working mechanism and decision making process of the SSBs,

(v) It has also become clear from the above that SABIC *sukuk* structure in its initial form had been inconsistent with the principles of *Shari'ah* as it has strongly resembled *riba*-based bonds in terms of the guarantee of the capital, returns, and the fact that there was no envisaging of real transfer of assets from the *sukuk* issuer to the *sukuk* holders. However, having said that by pointing out those inconsistencies, the SBSS has managed to modify the structure to match *Shari'ah* standards before marketing the SABIC *sukuk* to the investors.

5.4.2 Exploring the SSB's Role and Function in Examining the Relevant Documents

This section examines the responses provided by the SBSS' members as to whether they reviewed all the relevant documents in relation to SABIC *sukuk* issuance, which should include commitment of purchase, *sukuk* ownership transfer agreement, and *sukuk* assets management agreement among others**.**

The first member of the SBSS responded to this by stating that the SBSS had been aware of all the documents in relation to SABIC *sukuk*, which they had reviewed. In the meantime, the second member of the SBSS pointed out that the SBSS reviewed all the documents featuring SABIC *sukuk*, and yet the SBSS does not need to review some of the documents even though those documents have some implications for the SABIC *sukuk*, as he stated that the *sukuk* issuance features in documents totals to 500 page, written in the English language and that most of the information is irrelevant and has nothing to do with *Shari'ah* but rather involved financial and legal matters available for everyone. In addition, according to the third member of the SBSS, he noted that some experts in *Shari'ah* and other legal matters were presented with all the documents featuring SABIC *sukuk*. Eventually, after examining and reviewing the documents from those experts, the *sukuk* structure had been presented to SBSS and was explained for approval according to the third member of SBSS.

Based on the above stated account on the process of reviewing documentation related to SABIC *sukuk*, the following conclusion can be derived as findings through interpretative method:

(i) Two members of SBSS reviewed the relevant documents prior to their examination of the structure of SABIC *sukuk* whereas the third one did not;

(ii) The SBSS members failed to point out the exact documents that they reviewed;

It should be noted that the responses of the SBSS shows some variations. For instance, one of the members mentioned that the board had been aware of all documents featuring SABIC *sukuk*, while another member had pointed out that there is no need for reviewing all the documents involving legal and financial matters, and he stated that with regard to SABIC *sukuk*, the board had been focussed on documents

directly related to *sukuk* from *Shari'ah* perspective. In the meantime, a third member mentioned that all the documents were presented to experts in *Shari'ah* and legal matters in the first stage, and then they presented their decisions to the SBSS for approval, which could be through verbal explanation without the need for examination of the documents.

As can be seen, the role and function of SBSS in actual application is not necessarily close to the aspirational expectation of effectiveness in full procedural process even in document review.

5.4.3 Examining Pursuance of AAOIFI Standards by the SABIC *Sukuk* SSB

According to the first member of the SBSS, the board takes AAOIFI standards into account and benefits from it, which was the case with the SABIC *sukuk*. However, as articulated by the first member the SBSS has no commitment towards AAOIFI standards. The second member of the board maintained that *Shari'ah* boards allegedly state that they are committed to the AAOIFI standards, while he also stated that for them as a SBSS, they observe some of the standards and ignore others and make their own efforts in the form of *ijtihad* to avoid risks. However, the third member argued that commitment towards AAOIFI standards has always been there and that the SBSS is also members of the organisation that has approved the AAOIFI standards.

According to the answers given by the SBSS members in relation to the AAOIFI standards, the following points are concluded:

(i) The members of SBSS are also members of AAOIFI and all of them have taken part in the approval of those standards;

(ii) The analysis can identify a variation in the opinions among the members of SBSS with regard to the commitment to AAOIFI standards: two of the members of the SBSS believe that the board takes the standards into account without committing themselves to those standards, nonetheless, the board makes its own *ijtihad* in some cases; while the third member of the board stated that the members of the SBSS show commitment to the standards;

(iii) The members of the SBSS interviewed could not explain as to which standards they agree with and which ones they do not agree with, but they stated that they have

some reservation about them or the cases associated with Islamic financing and they have made efforts counter to AAOIFI standards as they stopped short of explaining that.

The analysis shows that despite the fact that AAOIFI is an internationally recognised body aiming to establish standards for Islamic financing in general and *sukuk* in particular, there is not much recognition among the *Shari'ah* scholars in everyday practice of Islamic finance.

5.4.4 Examining SSB's Post-*Sukuk* Issuance Roles and Functions

This section aims to examine the responses provided by the SBSS as to whether they undertake the post-*sukuk* issuance task of following up and controlling SABIC *sukuk* as required by AAOIFI Standards.

In responding, the first member of the SBSS responded by arguing that SBSS uses formal committees for control and supervision, and those committees compile reports on banking activities, including *sukuk*. However, according to the second member of the board, the SBSS does not undertake the task of control, supervision and follow up, adding that a condition set by *Shari'ah* boards of late calling for the task of follow up, supervision and follow up to be assigned to a separate board or otherwise to the same board that has approved the *sukuk*, but having said that currently as it is happening now a legal advisor has to be appointed to undertake the task of supervision and control of the activities associated with *sukuk* which has yet to happen in case of SABIC *sukuk*. As for the third board member, he denied any activities of the SBSS associated with supervision and control after the signing of the prospectus.

Taking the responses of the members of the SBSS into account in relation to this particular thematic issue, the following conclusions can be drawn;

(i) The SBSS has nothing to do with task of supervision and control of *sukuk* once those *sukuk* are presented to investors until the time of maturity;

(ii) The role and task of the SBSS was terminated at the endorsement of the issuance of the *sukuk* prospectus;

(iii) The activities of the SBSS is not shaped or restricted by the AAOIFI standards that stipulate that *Shari'ah* board has to undertake the task of supervision and control of *sukuk* after they are issued;

(iv) The responses of the SBSS have varied so that one of them mentioned that the SBSS formed committees to undertake the task of supervision and control, while the other members denied any activities of the SBSS and others associated with supervision and control.

Despite the fact that the members of SBSS who make it clear that *sukuk* structure need follow up and control from the date of issuance to the maturity date. However, a variation of opinion exists between the members of SBSS regarding SABIC *sukuk* whether there is a real supervision and following up after the approving the issuance or not. That should indicate that the absence of a general understanding of the duties of *Shari'ah* boards might cause many risks particularly with *sukuk* product which as it has been already mentioned *sukuk* need more examining and observing.

5.4.5 Exploring Potential Problems in the Application of AAOIFI Standards in SABIC *Sukuk*

This sections aims at questioning as to whether some barriers and problems exist in the application of AAOIFI standards to SABIC *sukuk.*

In exploring the problems and barriers in the application of AAOIFI standards in the issuance of SABIC *sukuk*, the second member of SBSS responded by conceding that some barriers exist featuring SABIC *sukuk* and the Saudi market in general. This is for the simple reason that like any other Islamic banking product the process of issuance of SABIC *sukuk* had to rely on *Shari'ah* standards besides the financial standards. In this regard, the product could be described as excellent from *Shari'ah* perspective, and yet could be inapplicable from a financial and banking perspective. This is where problems start to materialise and application becomes difficult. In this respect, the third member of the SBSS responded by denying any existence of barriers or problems featuring the application of AAOIFI standards to SABIC *sukuk*.

According to the answers given by the members of the SBSS involved in the SABIC *sukuk* issuance, the following conclusions are drawn:

(i) Disagreement exists among the members of the SBSS regarding the existence of barriers in relation to the application of AAOIFI standards to SABIC *sukuk*;

(ii) The members of SBSS failed to explain the reasons that stopped them short of application of AAOIFI standards to SABIC *sukuk*.

Despite the fact that specific standards exist featuring *sukuk* such as AAOIFI standards, which have been approved and recognised by many SSBs, such as the members of SBSS. However, the difficulty of practical application remains the main problem. The difficulty of application could be due to the fact that those standards are enigmatic and seem to be generalised or otherwise the application of those standards might make the product become unpopular among investors. Thus, there must be comprehensive and detailed standards to accommodate all structures known to all members of *SSB's* and in the meantime satisfy the requirements of investors in *sukuk.*

5.4.6 Exploring the Process of Decision Making Process within the SSB Approved the SABIC *Sukuk*

This section aims to examine the responses given by the members of the SBSS in relation to the decision making process within the SBSS and whether they followed an unanimous vote or simple majority. As the responses given by all the members of the SBSS interviewed indicate that normally in any structure the decision making process was based on simple majority.

According to the responses of the members of the SBSS the following conclusion can be drawn;

(i) SABIC *sukuk* was initially presented to the *Shari'ah* board featuring three members;

(ii) The members did not indicate any differences among them with regard to the process of structuring SABIC *sukuk* or otherwise showing any objection to one of the articles featuring the prospectus of issuance in its final form. Consequently, all the members signed the prospectus of issuance indicating their approval that they have no reservation on any article in terms of *Shari'ah* compliancy.

5.4.7 *Sukuk* Issuance and Common *Shari'ah* Standards

This section aims at exploring as to whether the s*ukuk* issuance should be subject to common *Shari'ah* standards as the case with the AAOIFI standards. All members of the SBSS responded to this question by stating that they agree to that arrangement, and two of them mentioned that they have also been members of the AAOIFI. Thus, it can be stated through the responses of the members of the SBSS that they are in agreement with the AAOIFI standards to be taken as a guideline by the SSBs, as none of the SBSS members interviewed has shown any discontent with those standards.

5.5 An Interpretative Discussion on the Established Findings

The discussion presented so far aimed at exploring SSB related issues in the case of the SABIC *sukuk* in particular (but also in general relating to the IF industry) through the perceptions and understandings of various stake holders. In an attempt to provide further critical understanding of the identified issues related to the SSB in this section, it is essential to discuss the findings so far established through analysing the primary data collected through interview survey from the field with experts such as *Shari'ah* judges, SBSS members, and academic staff or researchers who are interested in IBF and *sukuk*. In subjecting the findings to further analysis, the recommendations issued by the AAOIFI with regard to issuing *sukuk*, the AAOIFI standards for investment *sukuk* and the literature review will be all considered during the discussion and evaluation below.

5.5.1 Reflecting on the Importance of the SSB

As it has been highlighted that AAOIFI asserted the importance of having SSB in any Islamic banks and financial institutions. In this regard, many of those who were interviewed have maintained that the existence of SSB is essential as it tends to avoid many potential risks associated with Islamic financial transactions particularly *sukuk* business as it constitute a newly invented product which has yet to be tested in terms of the *Shari'ah* and legal risks involved particularly in Saudi markets.

In reflecting on the SABIC *sukuk*, it can be argued by many of the interviewees that what is the wisdom behind the importance of the existence of SSB and endorsed the prospectus of issuance, while many inconsistencies in terms of *Shari'ah* exist in many *sukuk* structures issued in Saudi Arabia as was the case with the SABIC *sukuk*

structure. Therefore, *Shari'ah* compliancy related inconsistencies exposed SABIC *sukuk* to many *Shari'ah* and legal risks putting probably the blame on the SSB which has a duty of securing the *sukuk* against any risks that involve the breach of the *Shari'ah*. For that reason, one of those who were interviewed indicated that the risk involving SABIC *sukuk* is the existence of SSB itself that has not been living up to its duties as it has to do.

On the other hand, according to one of the interviewees, the *Shari'ah* supervisory cannot be judged on their performance unless there is a clarity on what their job should be, whether it is sharing with people involved in the drafting of the *sukuk* from the beginning until the *sukuk* maturity with fully monitoring and supervision nor is it that the duty of SSB is only to approve the structure of *sukuk* without looking at any details or related documents or any type of supervision or following. In this regard, it should be mentioned that the aims and objectives of the existence of SSB within Islamic financial and capital markets especially with *sukuk* markets have been highlighted and explored during the literature review as well as according to the answers and comments made by the interviewees whether SBSS or others. Therefore, the advantages of having SSB can be surmised as follows:

(i) ensuring that all transactions should be based on *Shari'ah* standards;

(ii) playing an essential role for the development of the Islamic institutions in terms of products consistent with *Shari'ah* principles by responding to the demands of investors;

(iii) encouraging people to put and invest their money in the bank who has SSB;

(iv) ensuring that those organisations would not become involved in unlawful transactions such as the guarantee of the capital and returns in *sukuk* structures;

(v) it promote trust and reassurance among investors

(vi) avoiding the loss of the capital as the losing of the capital as result of involving in business that does not comply with *Shari'ah* principles;

(vii) avoiding to involve in *riba* and *gharar* transactions;

(viii) avoiding to be involved in prohibited sales such as *enah* and *wafaa etc.;*

(ix) giving advice to people who are involved in *sukuk* design so as to distinguish between which *sukuk* structures are allowed and which are forbidden

(x) raising people's awareness of the main problems and risks regarding the application of the Islamic financial products such as *sukuk;*

(xi) ensuring financial engineering and development of products be *Shari'ah* compliant in developing products in response to the needs of the society;

(xii) educating and training of staff and exchange of knowledge and experiences;

(xiii) ensuring the achievement of *Shari'ah* objectives (*maqased al-Shari'ah*).

From the above analysis, it becomes clear that having SSB's is an important but in the same time a perfect mechanism that guide the work of SSB's in order to achieve the goal of its establishment is crucial. Therefore, it could be argued that Islamic institutions have failed regarding issuing binding and a comprehensive standard for SSB's to be followed as well as clear methods to be implemented.

5.5.2 The Failure of *Shari'ah* Board to Undertake its Critical role

According to the AAOIFI (2010) the SSB must have the authority to supervise and control of the contract and structures following their approval by those boards. The real duty of the SSB was explained by one of the interviewees by stating that

> the SSB has a duty to follow up, control and supervise the *sukuk* from the time it has been approved by *Shari'ah* board to the time of maturation or clearance as to make sure that the *sukuk* progresses in accordance with *Shari'ah* principles and that no violations of *Shari'ah* principles have been committed that could transform them from Islamic *sukuk* to *riba*-based bond.

Despite such a comprehensive role assigned for the SSB, in the case of SABIC *sukuk,* however, it could be argued that the SBSS failed to provide a comprehensive supervision from the time of structuring and follow up. In this regard, one of the members of the SBSS pointed out that the structure of SABIC *sukuk* was designed and examined by *Shari'ah* experts before being presented to the SBSS as the duty of the SBSS is just to look at the structure and approve it after introducing some amendments to the structure that feature some inconsistencies with *Shari'ah* principles.

On the other hand, one of the members of the SBSS indicated that some committees emerging from SBSS undertake the task of control and supervision. Nonetheless, this matter was denied by the other two members of the SBSS, and that no reference exists to such committees in the prospectus of SABIC *sukuk*. However, the question that has been raised by many of those who were interviewed who are not among the SBSS with regard to SABIC *sukuk* related to who is the party who undertakes the task of following up and monitoring the SABIC *sukuk* process. That should imply that failure of the SBSS to undertake the task of following up, supervision and control will place SABIC *sukuk* at further risk with regard to *Shari'ah* noncompliance risks.

However, while one of the SBSS member is of the opinion that it is needles for the SSB to take part in structuring the *sukuk* as those who undertake that job have a good knowledge of *Shari'ah* besides wide experience in those matters; therefore, there is no need for *Shari'ah* boards to involve in such work. He therefore argued that, the board needs to focus only on reviewing *sukuk* structuring by making comments and that should end its task. However, that viewpoint can be rebutted by the argument that should those involved in the process of *sukuk* structuring by *Shari'ah* experts then the faulty *sukuk* would not have been presented to the board showing great resemblance to *riba*-based bonds as could be understood from the responses of two of the board members as presented above. On the other hand, another member pointed out that the duty of the board should not be confined only to the approval and endorsement of products, but rather should undertake the task of following up and control, and that has not been happening in the case of SABIC *sukuk*. In this respect, the AAOIFI has made attempts to extend the general concept of SSB suggesting that the SSB should incorporate expertise from all fields particularly economists, legal experts as well as experts in financial matters to assist the members of the board undertake their duties (AAOIFI, 2010).In addition, many of those who were interviewed have pointed out that the main problem and risk lies with the difference in opinion and *fatwa* among the members of the board regarding the definition of task to be undertaken by the *Shari'ah* board members. In this regard, SABIC *sukuk* is the case in point where opinion has varied regarding the exact task to be undertaken by the members as it has been asserted by the SSB. Therefore, it could be argued that the SBSS has failed to undertake the real task whether participating in structuring the models of the new and complex structure which is SABIC *sukuk*. In addition, examining and evaluating only

the summary of the prospectus of SABIC *sukuk* is considered one of the main risks that should be avoided.

As can be seen, *Shari'ah* scholars involved in SSB in ensuring *Shari'ah* compliancy of Islamic financial transactions, including SABIC *sukuk* mainly argue for passing their responsibility to other departments and individuals in banks and financial institutions by limiting their perceived task. By doing so, they accept the hegemony of the capitalist instinct over the essentialisation of Islamic moral expectations. This attitude will expose Islamic financial and banking transaction to *Shari'ah* non-compliancy risk and will further liberalise the Islamic banking and financial attitude by embedding it into capitalist forms of economy.

5.5.3 Failure of the SSB to Take Part in Designing the *Sukuk* Structure

Among the risks which SABIC *sukuk* have been exposed is that the SSB has failed to take part in designing *sukuk* structure as has been indicated by the members of the SBSS, which is discussed above. Consequently, those who have designed SABIC *sukuk* structure seem to be less knowledge in terms of *Shari'ah* therefore the SBSS discovered that the SABIC structure has been exactly similar to the structure of *riba*-based bonds as has been indicated by one of the members of SBSS. As a consequent, the failure of the SBSS to take part in the original design will expose SABIC *sukuk* to many risks such as overlooking some of *Shari'ah* inconsistencies that cannot be easily discovered without close investigation through taking real part in the design. That has really been highlighted by the confession of the one of SBSS members after the prospectus of SABIC *sukuk* was presented to him and after the deep discussion he held over SABIC *sukuk* on the ground that it contained some *Shari'ah* inconsistencies that were missed by the SBSS. Thus, it becomes a duty that the members of the SBSS should make a real contribution in the design of the financial structure, in the case the SABIC *sukuk* and should be aware of all stages of *sukuk* including the real risks in *Shari'ah*, legal and financial terms to which *sukuk* might be exposed and ways of avoiding those risks through *Shari'ah* means.

In other words, by undertaking their real role the SSB's will become effective in relation to developing the financial industry through new financial products that attract new investors in the Islamic financial markets.

5.5.4 Disqualifying the People who Proposed Structuring SABIC *Sukuk*

It could be argued that one of risk is the trust of the SBSS given to people who seem to be not qualified to structure SABIC *sukuk* as well as to review *Shari'ah*-based comments.

In this regard, it should be mentioned that the SBSS has relied on SABB *Amanah* bank to structure the SABIC *sukuk* before being presented to the SBSS. This process poses a risk as most of the bank staff might came from backgrounds featuring conventional banking expertise involving *riba*-based practices as it has been mentioned by one of the interviewee. For that reason, it should be noted that most of the financial products and structures they manage to draft mimic and resemble *riba*-based contracts and structures as that is for the simple reason that they have poor knowledge of *Shari'ah*. This explains as to what happened in the case of SABIC *sukuk* as it has been pointed out by one of the members of SBSS when he asserted that SABIC *sukuk* structure was initially presented to the SBSS as the same structure as bond structure with no difference.

In addition, it is assumed that the SBSS has undertaken its designated role involving the examination of the SABIC structure *sukuk*, and that the SBSS pinpointed some of problems associated with the structure in terms of *Shari'ah*. Furthermore, according to one of the SBSS, those comments were referred back to the relevant authorities to take them in consideration based on *Shari'ah* standards. However, as yet those non-*Shari'ah* compliancy issues are still exist featuring all issuances of SABIC *sukuk*, namely the first, the second and the third issuance indicating lack of follow up from the SBSS with regard to comments they make as has been pointed out by one of the interviewees who argued that the task of *Shari'ah* board end with referring back its comments to the issuer of *sukuk*, and yet the *sukuk* structure could be approved without the need to confirm that inconsistencies with *Shari'ah* compliancy are removed.

It should be noted that as indicated by respondents in the interview process, some of the comments made by *Shari'ah* board were ignored by the issuer of SABIC *sukuk*. According to one of the SBSS member when the SABIC *sukuk*'s prospectus presented to him during the interview, he mentioned that he would not have approved the

contents as it features inconsistencies with *Shari'ah* principles. That clearly indicates the lack of follow up by the SBSS to the comments it makes in improving the *Shari'ah* compliancy of the SABIC *sukuk* which might be a source of risk to SABIC *sukuk.*

5.5.5 The Dependence of the SBSS

An efficient corporate and good governance indicates that the members of the SBSS should be fully independent of the institution they are working for to avoid any conflict of interest in views between them and the bank or company that has issued the *sukuk* as it has been suggested by the AAOIFI (2010) as well as the Islamic *Fiqh* Academy decision No 177(3/19). However, the members of the SBSS are dependent on the SAAB bank as they work for it as *Shari'ah* consultants which might lead to the risk as it has been indicated by some of those who have been interviewed. Thus, the independence of the members of SBSS from *sukuk* issuers will promote assurance among investors whether that being with SABIC *sukuk* or other products in relation to Islamic financing.

5.5.6 The Members of SBSS Having Various Other Tasks and Jobs

It should be mentioned that one of those who were interviewed mentioned that many of the *Shari'ah* scholars who are well informed in matters concerning Islamic financing have to face a major problem due to the fact that they take part as members of many international and local *Shari'ah* committees. This might lead them to not have the time to provide proper *fatwa*, follow up and control of *sukuk* they have approved. That seems to be the case with the SABIC *sukuk* as the members of the board have been members of other boards of banks in Saudi Arabia as well as other countries as it has been indicated in table 5.1.

Table 5.1: Matching Between the Members of SBSS and the Numbers of Institutions they Work for

Members of SBSS	The number of institutions they work for	The number of *sukuk* they approved
1	41	91
2	81	222
3	17	66

Data Source: Zawya (2016)

In addition, they are being engaged in activities associated with the government as well as other charity organisations. Therefore, it could be difficult for them to find enough time to examine and study the SABIC *sukuk* structure with all the relevant documents and aspects as well as to undertake the task of a full supervision and control following the approval of SABIC *sukuk*. Consequently, those boards have entrusted the bank with the task of control and supervision or to the party that has issued the *sukuk* without any follow up from them which constitutes a risk given that the bank or company can be only concerned about maintaining their profits, the value of *sukuk* and the reputation of organisation no matter the *sukuk* being consistent with *Shari'ah* principles or not.

In this regard, many of those who have been interviewed have suggested that members of the boards should have had the maximum time allowed to take part in the study of the SABIC *sukuk* structure before the final approval as well as the involvement in other committees should be limited. However, they are in the view that this should be a general practice for all the Islamic financial products. In addition, it has been also suggested that as long as SBSS has a duty to undertake its role in the follow up and control or otherwise designate that role to an independent party featuring experts and specialists in *Shari'ah*, legal and financial matters to undertake that role on its behalf.

5.5.7 Failure to Review all the Documents and Information Relevant to SABIC *Sukuk*

The judgment to be made by the *Shari'ah* board regarding any financial products cannot be relied on or accepted from *Shari'ah* perspective until there is full understanding, which should have been the case for the SABIC *sukuk*. In this regard, Ibn-Al-Qayyim (2002) stated that what has plagued this nation is the lack of understanding of the *Shari'ah* rules as well as the lack of understanding of the reality, most importantly, the lack of understanding of how to match one over the other, therefore, the understanding is a great asset in *Shari'ah.* Therefore, it is unconceivable to make a judgment on any case as to whether or not it agrees with *Shari'ah* principles unless the whole case is conceived and the relevant documents are reviewed that help the *Shari'ah* board to understand the case in question as it has been decided by the *Shari'ah* scholars (Ibn Othaymeen, 2007). However, in case of SABIC *sukuk*, the

members of the board needed a great deal of time and effort to understand the structuring of SABIC *sukuk* especially the SABIC *sukuk* structure considers a new and complex structure since it is consisted of deferent contracts and then make a judgement according to their understanding. Their task normally also includes reviewing all the documents; and this is the case for SABIC *sukuk*, which featuring documentation such as contracts between SABIC company and its subsidiary companies, the purchase commitment agreement, the transfer of ownership of *sukuk* assets agreement, the agreement of management of *sukuk* assets *etc*. However, as discussed above, the members of the SSB did not review all the relevant documentation, which indeed paves the way for a potential non-*Shari'ah* compliancy risk.

As discussed above, the members of SBSS have been indifferent about reviewing all papers and documents relevant to SABIC *sukuk*. As one of members of the SBSS indicated that it has not been important to review all the documents in the presence of specialised committees that undertake the role of studying the structure in terms of *Shari'ah* and then the structure will be presented to *Shari'ah* board for approval. On the other hand, another member indicated that the long prospectus of issuance could constitute an obstacle in addition to the language barrier so that reading the full prospectus of issuance is not needed. Thus, the fact that the SBSS only becomes aware of the summary of the prospectus of issuance will expose the SABIC *sukuk* to the risk of SBSS not being aware of some inconsistencies with *Shari'ah* compliancy that have not been originally included in the summary of prospectus of issuance which will be discussed in details in next chapter. Thus, if the *Shari'ah* board becomes aware of any misspecification in *Shari'ah* compliancy, it would definitely not approve the structure, and yet those details are missing in the summary of the prospectus of issuance that has been signed by the SBSS.

However, the question which has been raised from one of the interviewee is that, why the members of SBSS has failed to review all the documents relevant to SABIC *sukuk* as it has been mentioned from two members of SBSS? Is it because the documents featuring financial and legal matters are insignificant as to be reviewed as has been mentioned by one of the SBSS or otherwise, because those documents have already been reviewed by legal and *Shari'ah* experts so that they do not need to be reviewed

again given that those experts have been trustworthy in terms of their expertise in relation to *Shari'ah*, legal and financial matters, whereas the SBSS may be is not qualified in legal and financial matters or otherwise the documents are too long and written in the English language as has been mentioned by one of the members of SBSS. Regardless of the reason, the fact is that the party that made the structuring failed to provide the *Shari'ah* board easy access to the relevant documents as one of the interviewees pointed. It should be noted that AAOIFI has made it clear that bank managers and directors of financial organisations have a duty to make it easy for the members of SSB to access every bit of information relevant to the product under investigation (AAOIFI, 2010). In addition, it seems that there was no particular demand to see such documentation, as the members of the SBSS were engaged in a number of activities and panels featuring banks and financial organisations so that they had no time to review all the documents. Thus, the practice cannot be considered as a good practice in terms of relinquishing the expected tasks from the *Shari'ah* scholars.

As the discussion above indicates, most of those who have been interviewed have also made it clear that the SBSS members need to meet the persons who have something to do with the SABIC *sukuk* no matter those persons being accountants, legal persons or any other persons for the purpose of full understanding the *sukuk* structure, which will help them to the understand and identify the assets underlying *sukuk* and whether the *sukuk* holders really own those assets through reviewing the accounting and financial records. Eventually, that will make the *Shari'ah* scholars to understand the procedures involving the transfer of assets from the *sukuk* issuer to *sukuk* holders from the legal perspective, which will, consequently, will help the *sukuk* holders to identify as to whether they are capable of dealing conclusively with the assets they own or otherwise the ownership has been just a formality.

Moreover, it should be mentioned that some of the SBSS members seem to be indifferent with regard to reviewing all the documents relevant to *sukuk* so that failure of full and careful examination of the documents featuring *sukuk* could place the *sukuk* at the risk of not being *Shari'ah* complaint.

It could also be argued that the members of the SBSS need to be fully aware of the process of reviewing and evaluation the structure issuance as a whole and not part of

it as it has been indicated by Ibn Al-Qayyim (2002). In this regard, SBSS might focus on the structure of *sukuk* only through the summary of the prospectus and find out if the structure is intact to verify the Islamicity or the *Shari'ah* compliancy for eventual approval. Such procedure is defective as has been pointed out by one of the interviewees by saying that

> Some of *Shari'ah* boards perceive the process of *sukuk* structuring which mostly features between one and two pages and consistent with *Shari'ah* principles. However, when it comes to the details and the main prospectus of issuance and the relevant documents, one might discover a different wording or even sometimes by comparing the structuring to the prospectus of issuance inconsistencies exist. The board has approved something; however, application is something different, as it could be argued that the mission of SSB is just to make the approval of the product.

As opposed to such a simplistic approach, as discussed in detail, the role of the SSB should go beyond the approval of the structure but instead their task should include the close examination of the structure, the prospectus of issuance as well as any other relevant documents according to one of the Interviewee. In this regard, it should be mentioned that the SBSS opted for a pragmatic solution as it signed on the summary of the SABIC *sukuk* which could mean that they failed to examine and evaluate the main prospectus which has many of the critical *Shari'ah* issues which will be discussed in next chapter.

Therefore, it becomes obvious that the SBSS has come short of reviewing all documents associated with the prospectus of issuance of SABIC *sukuk*. However, the focus has been only on the summary prospectus of SABIC *sukuk* without giving more attention to the main prospectus of issuance which could give the real picture of the structure and its consistence with *Shari'ah* principles. Such behaviour of SBSS could have negative effects. As a consequence, failure of making a full conception of structure will definitely lead to a judgement that might be inconsistent with *Shari'ah* principles according to the rule "judgement of something should always constitute part of its conception". In other words, the judgement will not be valid and consistent with *Shari'ah* principles unless the members of SSB have full conception of the structure in question.

5.5.8 Failures of Control and Follow after *Sukuk* Being Approved

The AAOIFI standards stated that the *Shari'ah* board has to be involved in controlling as well as monitoring *sukuk* from the time of issuance until maturity. That will provide guarantee of the performance of the product in a way consistent with *Shari'ah* principles and it will not veer from the right track of *Shari'ah* through close control and follow up by the members of *Shari'ah* board. However, in case of SABIC *sukuk* some of the members have indicated that some sort of underperformance exists in this aspect which has made *sukuk* consistent with *Shari'ah* principles and then latter it veers from *Shari'ah* track due to lack of those who control and follow up.

As has been explained above, *sukuk* are still considered new products featuring Islamic financial markets and need more examining and investigation. For that reason, SSB's have to put more effort in controlling and examination of *sukuk* performance from the beginning of issuance to their expiry date. However, such a task could be very difficult for SSB's in general and SBSS in particular due to their involvement in numerous financial institutions as it has been indicated in table 5.1. Nonetheless, it could be said that the establishment of specialised centres to undertake such duties could provide a suitable solution given the shortage in the number of *Shari'ah* scholars specialised in Islamic finance.

5.5.9 Observing and Following the AAOIFI Standards

As discussed previously, AAOIFI is an internal standard developing body for the Islamic financial institutions, whose standards remain voluntary in most of the Muslim countries; as only a couple of countries have formally instituted the AAOIFI standards for their Islamic finance industry. As far as AAOIFI standard is concerned, it has its own standards in relation to *sukuk* as main purpose of those standards is to become a reference for IBF so as to eliminate the risk of disagreement among the various stake holders in terms of the *fatawa* they make. To reach that end, the AAOIFI has managed to bring together a leading *Shari'ah* scholars and specialists in Islamic financing who have managed to set those standards as a reference to *Shari'ah* boards when examining any of the products associated with Islamic financing such as *sukuk*. It is worth mentioning that all members of SBSS are also prominent members of the AAOIFI. Those members, however, stressed the need for such standards to provide a guide for those who work in the area of Islamic financing in general and the

area of *sukuk* in particular as the latter constitutes a new product that needs to be supported and developed in favour of companies seeking financing.

Nonetheless, it could be argued that the failure of the SBSS to observe those standards as it has been mentioned by two of the members SBSS should expose SABIC *sukuk* to great risks as it has been indicated by the majority of those who have been interviewed. It should however be mentioned that the members of the SBSS had shown their consent to the existence of the AAOIFI standards, and yet in another position of the interview they mentioned that they should not commit to the AAOIFI standards and instead should make their own *ijtihad*. In this regard, it could be argued that the main risk associated with such positioning is that when there is an announcement as a *fatwa* from other *Shari'ah* scholars pointing out that there is no *Shari'ah* compliancy in the structure of SABIC *sukuk*, as it has been stated by Merah (2011), this would put the whole Islamic finance at risk by shaking the foundation of the industry. Therefore, the observing as well as following any standard such AAOIFI as a *Shari'ah* guideline should be a solution for such risk as it has been suggested by the AAOIFI regardless of the position taken by some of the interviewees, in particular *Shari'ah* scholars.

On the other hand, a clear discrepancy exists between AAOIFI standards with regard to *sukuk* and the *fatawa* issued by the members who have approved the standards. The fact of the matter is that the three members of SBSS are also members of AAOIFI, and yet SABIC *sukuk* feature some *Shari'ah* issues which are against the AAOIFI standards (these issues will be discussed in the next chapter). However, the subsequent risk is the absence of reliable common standards to be observed by all *Shari'ah* boards as it has been suggested by (DeLorenzo, 2006; McMillen, 2006). In addition, it could be argued that there is no point of signing standards without putting them into practice, a matter that will definitely make customers mistrust the whole process of Islamic finance.

It should be noted that all the SBSS members interviewed have agreed that they have not been committed to the standards in the issuance of the SABIC *sukuk* as stated by AAOIFI with regard to *sukuk* given that they are members of AAOIFI. Subsequently, examining and approving the structure of SABIC *sukuk* has been based on the views and efforts of the members of the SBSS rather than being subject to standards issued

by considerable sources. Therefore, failure to be committed to those standards will cause confusion in *fiqhi* view between the various *Shari'ah* boards which makes the structures on which SABIC *sukuk* has been designed are consistent with *Shari'ah* standards for one *Shari'ah* board and inconsistent for the other (DeLorenzo, 2006; Alshamari, 2013), which has been asserted during the interviews as well as. Therefore, many demands are made by those who have been interviewed and others who are concerned about the Islamic economy that there must be some standards to be observed by all *Shari'ah* boards on which their judgment are made.

5.5.10 Lack of Reference for *Fatawa* Associated with *Sukuk*

It could be argued that there is no single provision exists in the AAOIFI standards that indicate that the SSB should be committed to the standards during examination of *sukuk* structures. Accordingly, the SBSS has not observed as well as organised the AAOIFI standards as has been already mentioned. As a matter of fact, the absence of standards for SSB's to rely on regarding their examination of the products of Islamic financing including *sukuk*, can result in disagreement of *fatawa*. That has been obvious with regard to the structuring of SABIC *sukuk* as the members of SBSS are in disagreement with regard to the consistency of SABIC *sukuk* with *Shari'ah* principles as it has been indicated during the interview section.

5.5.11 Issuing the Legal Decision (*Fatwa*) by SBSS

According to AAOIFI (2010), the members of *Shari'ah* board that examines and approves the contracts should not be less than three members which is exactly the case with SBSS. Nonetheless, the question is whether the three members are sufficient to examine such *sukuk* structure which is considered as a new product that needs individuals who are well informed and knowledgeable of the basic principles in relation to legal and financial matters besides their knowledge of *Shari'ah* matters, so that through the diversity of knowledge available to them they would be capable of judging the product from every aspect as it has been suggested by one of the interviewees. Consequently, the inadequacy of the number of SBSS member is considered among the risks that have to be paid attention to in the next issuances.

On the other hand, the prospectus of issuance of SABIC *sukuk* indicates that SBSS agreed unanimously on the contents of the prospectus of SABIC *sukuk* as being

Shari'ah compliant. However, by assuming that if one members shows objection to some of the articles or otherwise have some reservations to some of what has been mentioned in the prospectus of issuance in terms of its consistency to *Shari'ah* principles, then in this case the vote will be two against one which is not sufficient to judge a product with the complexity of the structure as SABIC *sukuk* considered.

It should be also noticed that the summary of the prospectus of SABIC *sukuk* features the signature of the three members of SBSS indicating their approval without any reservation. Moreover, by interviewing the members of SBSS, it has become obvious that one of the SBSS had opposed to some of the articles featuring the prospectus of SABIC *sukuk* in terms of their *Shari'ah* principles. It could be argued that one of the reasons is that he might have not read the prospectus of SABIC *sukuk* carefully or he changed his mind with regard to a specific issues when he had seen some practical issues happening in the ground which against the *Shari'ah* rules.

Therefore, the potential of changing the *fatawa* issued by SSB's constitutes a major *Shari'ah* risk as it has been pointed out. In this regard, it has been suggested that different structures have to be designed in advance by some experts and reliable institutions. Such structures should not give any chance to individual SSB's to approve structures which could be subject to become inconsistent with *Shari'ah* principle.

5.5.12 The Lack of Diversity Among the SBSS in Terms of Specialisation

The different specialisation among the SSB members is highly needed as indicated by interviewees. In addition, the approval of any *sukuk* structure has to be based on a comprehensive view in terms of *Shari'ah*, legal and financial aspects. Consequently, any judgment (*fatwa*) to be made should be consistent in terms of *Shari'ah* as well as the legal aspect as to avoid any potential *Shari'ah* and legal risk. It can be said that many of the recent *sukuk* structures are most likely to be considered complicated and do not based on real assets as the case with SABIC *sukuk*. Such structures need to be well understood both financially and legally. Thus, accordingly, the SSB's should include specialists in law and finance and have a well background in *Shari'ah* contracts in order to reach the right decision as it has been suggested by AAOIFI (2010).

5.5.13 Lack of the Necessary Law for the Accountability

The absence of the accountability law for calling members of SSB's to be questionable in case of the their failure could expose SABIC *sukuk* structure to the risk of being inconsistent with *Shari'ah* principles as it has been noted by Khorshid (2012). Accordingly, some of the interviewees believe that a law must be made to incriminate responsible for underperformance in some of SSB's regarding their approach of approval of the products of Islamic financing. However, having such a law will make SSB's doing their best before approving any *sukuk* structure.

5.6 CONCLUSION

As the discussion so far indicates, a number of *Shari'ah* risks related to SBSS have been highlighted in this chapter, which are summarised in Table 5.2. The concept of *Shari'ah* supervision is still not really cleared as it has been discussed above. In addition, the comprehensive as well as a proper *fatawa* will play an essential role for making the *sukuk* structure consistent with the principles of *Shari'ah*. Therefore, it can be concluded that SABIC *sukuk* issuance has been exposed to different risks related to the real functioning of SBSS as also highlighted in Table 5.2. In other words, the members of SSB's should provide a guarantee for the *sukuk* structures as to avoid resemblance *riba*-based bonds. This could be through taking part in all the steps of structuring and developing the *sukuk*. In this regard, the Islamic financial institutions and research centres have to play a major role in the studies of the needs of the market with regard to the development as well as standardisation.

The next chapter will discuss and examine the SABIC *sukuk* structure through the data collected from the research field on the SBSS'

Table 5.2: Established Risks Related to SABIC *Sukuk*

No	The evaluation points	Risks Related to SABIC *Sukuk*
1	The clarity of duty and responsibility	The SBSS members are in different opinions with regard to their duties and responsibilities which have to be undertaken
2	Participating in designing the structure	Failure of SBSS to take part in designing the structure of SABIC *sukuk* in the first stage
3	clear method and mechanism	The lack of clear method and mechanism when the SBSS do their examination of SABIC *sukuk* structure
4	The contribution of all the members to review all the documents	Not all of the members of SBSS have reviewed the relevant documents prior to their examination of the structure of SABIC *sukuk.* It seems that the SBSS members just read and focused on the summery of SABIC *sukuk,* which contained the SBSS's signature, rather concentrating on the main prospectus.
5	The real of supervision	Failure of SBSS to undertake the task of supervision and monitoring of the SABIC *sukuk* as the role and task of the SBSS terminates at the endorsement of the issuance prospectus
6	Ensure that all *Shari'ah* observations have been modified	Lack of follow up from the SBSS with regard to comments and objections they make after the first observation
7	A comprehensive examination and study	Focusing on the structure itself without any consideration to the result and the consequences.
8	Consistency and harmony among the all documents	The differences between the main prospectus and the summery of SABIC *sukuk* have been discovered as there are many critical issues have not written in the summery
9	Observing AAOIFI standards	A variation in opinion exists among the members of SBSS with regard to the commitment to AAOIFI standards
10	Observing a reliable standards	No standard to be Observed and followed during the examination and evaluation such as AAOIFI standards.
11	Internal *Shari'ah* committee	NO internal *Shari'ah* committees under the SBSS to undertake the task of supervision and control
12	The unification of *fatwa* and the sustainability of the legal decision	The members of *Shari'ah* board are in disagreement with regard to the consistency of SABIC *sukuk* with *Shari'ah* principles
13	Consistency of jurisprudence verdicts	Differences between the SBSS and other *Shari'ah* scholars with regard to the consistency of SABIC *sukuk* with *Shari'ah* principles
14	The quality of people involved in the structuring of *sukuk*	Disqualifying the people who proposed structuring SABIC *sukuk* in the first stage as the SBSS has discovered that the structure of SABIC has been exactly similar to the structure of *riba*-based bonds
15	The participation of experts during structuring *sukuk*	The failure of SBSS to make any connections with other specialists during the studying and approving the SABIC *sukuk* for the purpose of having full understanding the structure of SABIC *sukuk*
16	Adequacy of the number who is participating in examining and approving the structures of *sukuk*	The members of SBSS seem to be not enough to approve a new product with new and complex structures such as SABIC *sukuk*
17	Specialization in the members of SSB	The lack of diversity among the SBSS in terms of specialisation
18	The ability for evaluation and adequate examination	The members of SBSS seem to be busy with many occupations
19	Independence	There is no independence for SBSS as the SBSS should be fully independent to avoid any conflict of interest in views between them and the bank or company that has issued the *sukuk*

Chapter 6

SHARI'AH RISKS IN SUKUK STURUCTURES

6.1 INTRODUCTION

It is essential to know that the risk which related to the *Shari'ah* compliance is the main risk that *sukuk* structures are exposing to in the current financial market as it has been pointed out by Tariq (2004) and Kahf (2006) among others. In this regard, the non-*Shari'ah* compliance risk refers to the possibility of occurrence of circumstances where the financial service or product is not or will not be in compliance with established *Shari'ah* principles and standards (DeLorenzo, 2006). The importance of examining and evaluating the subject of *Shari'ah* non-compliance risks is essential as the *Shari'ah* regulations and principles are considered as the key features of Islamic financial institutions that the customers do emphasise, while ascertaining the extent of the bank's adherence to the regulation (Iqbal *et al.*, 1998). Mostly, what distinguishes Islamic financial institutions from other institutions is its commitment to the provisions of *Shari'ah* as the articulation of Islamic morality in all its dealings (El-Hawary *et al.,* 2007).

It should be noted that in the previous chapter, the risks associated with SSB with regard to SABIC *sukuk* are identified and critically discussed. This chapter attempts to discuss the essential *Shari'ah* issues in relation to *sukuk* structures in general and SABIC *sukuk* in specific. Therefore, this chapter is divided into three parts as the first part discusses and explores the critical issues associated with *Shari'ah* non-compliance risks; while the second part aims to report and discuss the position of the SBSS, particularly with regard to the issues related to the structure of SABIC *sukuk* through the opinions and perceptions of the participants in the interview schedule. The third section discusses and examines the structure of SABIC *sukuk* and the related documents from *Shari'ah* perspective as any inconsistency with *Shari'ah* rules and principles is considered as leading to risks.

6.2 *SHARI'AH NON*-COMPLIANCE RISKS: A CRITICAL LITERATURE REVIEW

In order to provide a detailed discussion on *Shari'ah* non-compliance risks, the discussion is formed around a thematic method by referring to a number of issues. However, in order to make a better sense of such issues, this section commences with a sub-section, which compares *sukuk* and bond structures.

6.2.1 Comparing *Sukuk* and Bonds Structures

While the Islamic financial markets have been spread with many *sukuk* with Islamic description, Usmani (2007) argues that in their engineering the main aim has been to make sure that those *sukuk* can compete with the *riba*-based or conventional bonds and that most of the *sukuk* available in the markets carry most of the characteristics of conventional. He further contends that this is done with the objective of making them easily promoted in the Islamic financial markets**.** However, he pointed out that the characteristics associated with *riba*-based bonds should not be contained in Islamic *sukuk* as a direct consequence. However, the reality is that *sukuk* have been transferred from methods of investment to become methods of funding; and therefore those who work in *sukuk* have attempt to make their *sukuk* to acquire many of the characteristics associated with *riba* funding bonds in an indirect manner through finding different methods as part of their financial engineering so that they should be marketable.

Almenea (2010) asserted that the main aim of issuing *sukuk* is to become a replacement for investment in bonds that are considered as *riba* based for borrowing. However, in support of Usmani (2007), he also argued that most of the issuances of the current *sukuk* have not been on the right track in terms of *Shari'ah* and instead they Islamic *sukuk* in their forms while in the reality they represent faked structures based on *riba* which apparently appear to be following *Shari'ah*. In this respect the decision of the Islamic *Fiqh* Academy's No 188 (3/20) stated that "Islamic bonds "*Sukuk"* must to demonstrate the fundamental differences between them and usury bonds in terms of structure, design, construction, and the need to reflect them on the marketing mechanisms and pricing".

It is at this point identifying the differences between Islamic *sukuk* and *riba* based bonds as follows (Adam and Thomas, 2004; Usmani, 2007; Tariq and Dar, 2007):

(i) The bonds represent an amount borrowed by the issuer and have nothing to do with assets, while *sukuk*, on the other hand, represent parts of available properties belonging to projects or investment activities;

(ii) The bond holder is not affected by the outcome of the company activities nor it is affected by its financial status, as it deserves the nominal value of the bond at specific date plus the required profits, while the *sukuk* holder is affected by the activities of the project as it shares profit and losses and also shares the risks involves;

(iii) The returns on bonds are a commitment to be made by the borrower (the bond issuer) that should be a commitment in the form of a return of the bond that will be added to the capital; therefore, it becomes a *riba*. In addition, the relationship between the bond holder and the issuer becomes a 'relationship borrower creditor', and yet, the returns of *sukuk* have nothing to do with the issuer, as the returns are not a commitment to be added to the nominal value. On the contrary, the returns on *sukuk* are profits due to activities as a result of using the money (raised by *sukuk*) to be paid by *sukuk* holders. Moreover, the nominal value of *sukuk* is not guaranteed by the issuer so that they will not be a debt on the source;

(iv) The bonds holder has the priority to obtain the nominal value of the bond he carries in addition to the other profits no matter whether the project has gained or lost. Thus, the issuers of bonds have a duty to return the capital besides the profits agreed upon to the bond holder. However, *sukuk* holders have no priority but rather will be paid some of the percentage from what have remained from the project assets after the payment of debts to debtors.

These differences are presented in Table 6.1.

Table 6.1: Comparing *Sukuk* and Conventional Bond

Comparison Reference	*Sukuk*	Bonds
Represent	Assets, usufructs, services, rights	Pure debt
The holder	Is affected by the financial status of the issuer	Is affected by the activities of the project
The relationship between the issuer and the holder	Based on the nature of the contract whether *musharakah mudarabah etc*	Creditor and borrower relationship
The returns	According to the project performance	A commitment on the issuer
The capital	It is not guaranteed	It is guaranteed by the issuer

It could be argued that the transformation of *sukuk* from investment structure to financing structure by trying to attach *sukuk* some characteristics of *riba* based bonds that have been popular among investors tend to raise issues around the legality of *sukuk* from the *Shari'ah* perspective. Therefore, the following *Shari'ah* issues are expected to arise in the issuance of *sukuk*: the ownership of *sukuk* holders to the assets, the guarantee of the assets and the returns, the actual transfer of assets from the issuer to *sukuk* holders, and other *Shari'ah* issues associated with *sukuk* (Merah, 2008; Merah, 2011). It should be mentioned that these issues have been discussed by many *Shari'ah* scholars and academic researchers as well as AAOIFI and Islamic *fiqh* Academy, which therefore constitute the content of the discussion in this chapter and they are discussed in the following sections.

6.2.2 The Reality of the Ownership (Legal and Beneficiary Ownership)

The decision of the Islamic *Fiqh* Academy's No 188 (3/20) stated that "*Sukuk* contracts should fulfil all the requirements whereby ownership is legitimately and legally proven, resulting in the ability to act and afford insurance. Contracts should be free from fraud and sham and insuring that they will ultimately guarantee safety from the *Shari'ah* point of view".

In this regard, Usmani (2007) also asserted that *sukuk* have to represent the right of ownership no matter being ownership of properties, usufructs or services, and therefore *sukuk* should not represent a debt for profit on the issuer. This is the main character that differentiates *sukuk* from *riba*-based bonds. In addition, according to AAOIFI (2010) "*Sukuk*, to be tradable, must be owned by *Sukuk* holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of *Shari'ah*".

As it has been mentioned by AAOIFI (2010) that one of the benefits of *sukuk* with regard to investor who carries the *sukuk* is that *sukuk* holders have to enjoy the full rights of their ownership to *sukuk* assets, as *sukuk* represent common gains in real assets. In other words, the sale contract must be real by transferring the assets in terms of *Shari'ah* and by law from the balance sheet of the seller to the register of *sukuk* holders by giving them all the rights by full behaviour of the assets such as sale, rents without restrictions that prevent them from doing so.

According to the authentic *Shari'ah* position contracts that include things and conditions that constrict ownership would still be considered valid and viable. However, due to some features and conditions, certain *sukuk* structures can be considered as unreal and fictitious, as there is no real intention for sale (Merah, 2011). Some of such conditions include; *sukuk* holders have no rights to sell *sukuk* assets or do anything including selling or marketing the products of assets. In addition, *sukuk* holders have no right to introduce any amendments in relation to the conditions to do with the issuance or otherwise do any restrictions without the consent of the issuer (Almenea, 2010; Merah, 2011).

It is quite clear that those conditions and restrictions indicate that ownership does not allow the owner to have all the rights to behave in full in its ownership as it has been stated by AAOIFI (2010) as well as the decision of the Islamic *Fiqh* Academy's No 188 (3/20). Given the fact that the main feature of *sukuk* as compared to bonds is the availability of ownership, *Ibn Taymiyyah,* therefore; explained the meaning of ownership by saying that the full ownership; where the owner has full authority to sell or offer or otherwise rent or any other uses (Ibn Qasem, 1995). On the same issue, Alkhafeef (1996) pointed out that the ownership of anything that makes the owner has a full authority to claim the ownership unless that becomes not possible due to *Shari'ah* barriers that prevent that.

In further exploring ownership issues, Hassan (2012) stated that the ownership can be either full (asset and usufruct) or otherwise incomplete ownership (beneficiary ownership). In the case of the latter, benefit incurs by using the asset for specific period of time, such as, the one who sells the *manfa'a* of the asset to be owned to *sukuk* holders for certain period of time which is known as the 'tangible assets *sukuk*'. This also can occur in the cases where an individual buys a usufruct of asset for certain period of time (90 years as *ijarah* contract), and then manages to sell to *sukuk* holders which is known as (*sukuk al manfa'a*) in which case he owns the benefit but not the asset as he is renting the asset. Abu Zahra (1976) also has the same view that the ownership is divided into full ownership by the asset and usufruct, and not full ownership which involves the asset only or the usufruct only.

Hassan (2011) argued that the ownership, whether it is full or not (beneficial ownership), should be transferred in *Shari'ah* terms once the sale contract has been

fully accommodated to match its conditions and constrictions according to *Shari'ah* law, whether the ownership of the assets has been recorded by the government office or not. In other words, the transfer of property from the register of the seller to the register of buyer should not constitute a condition in *Shari'ah* to satisfy the right of the sale.

Hassan (2012) also argued that it is not allowed under the principle of *Shari'ah* to transfer the 'beneficiary ownership' to the *sukuk* holders and in the same time holding the title (the real ownership) of the assets under the name of the issuer. In addition, he pointed out that the term 'beneficiary ownership' does not considered in *Shari'ah* law as it has been used for securitization of the returns of the stocks or the right of receiving the rentals from the lessees of an asset. Therefore, the scholars have to agree on the opinion that securitization of debts, rights and interests linked to assets should be prohibited. Furthermore, the beneficiary ownership of the assets should be transferred fully according to a *Shari'ah* complaint sale agreement as there is no need to register the assets legally as long as the sale reached the requirements of the *Shari'ah* law.

According to Dusuki and Mokhtar (2010), the beneficiary ownership does not have the same impact as in the legal ownership for several reasons. One of these reasons is restrictions usually imposed on *sukuk* holders in the disposition of the assets owned by them during the period of the *sukuk*, because they are considered as the owners for just usufruct. Additionally, if any disagreement accurses, under the beneficiary ownership system, the *sukuk* holders cannot dispose of the assets by selling them, as they are not legally registered under their names but still under the name of the main seller. In this regard, the asset probably transferred to SPV, however, the SPV in most cases owned by the original owner. Consequently, it is still under the authority of the seller as the transition seems to be unreal. Accordingly, the ownership in the asset-based *sukuk* structure is considered incomplete in terms of *Shari'ah* rules due to the lack of the ability of the *sukuk* holders to dispose their assets by selling or giving to others as charity *etc*. Hence, there is an urgent need to recognise the fact that most of the *sukuk* structures are assets-based rather assets-backed. This has a negative impact on the ownership of the *sukuk* holders whether is it according to *Shari'ah* rules or not as it has been noticed above.

It should be stated that the most important features that differentiate between the full sale and incomplete sale in terms of *Shari'ah* is the ability of the buyer in disposition of the assets purchased through sale to a third party and this in fact does not take place under the term of 'beneficiary ownership technique'. In this respect, it should be mentioned that one of the *maqasid al Shari'ah* is to maintain and ensure the rights with the application of transparency principle in financial transactions.

With regard to the 'beneficiary ownership', it should be noted that after the global financial crisis, it turned out for many investors that in fact, they cannot dispose of assets they bought in sale as they are classified as 'beneficial owners'. Therefore, it could be argued that the 'beneficiary ownership technique' might be chosen in the case of failure to prove full ownership due to the laws of the country in ownership of foreign investors as it has also been explained above.

OIC and Malaysian Negara Bank resolved the controversy in the subject of 'beneficiary ownership' within the terms of *Shari'ah*. However, it has been stressed that the beneficiary ownership must be transmitted with all the rights and obligations from the issuer to the new owner of the assets (*sukuk* holders). To achieve this condition, some *Shari'ah* scholars with legal experts found a practical solution in the common law of trust. At common law, there is so-called '*trust system'* which is when the person (mostly the seller) holds and keeps the asset sold to someone under his name according to the 'trust law'. The purchaser is considered as an owner of the usufruct of the asset in common law. The asset will be hold and kept under the name of another person called *(the trustee*). The relationship between the two will be the relationship between the beneficiary and trustee documented by a trust deed executed (often unilaterally) by the settlor.

This relationship entitles the owners of the usufruct to a convenient access to the assets they own through the trustee even though it is not registered in the purchaser' name. However, it is kept with the seller under the 'trust law'. Therefore, if there is any dispute, the original owner, who is here called 'beneficial owner', due to inability to register his/her name is able to dispose of the owned assets according to the 'trust law'. Accordingly, under the common law of trust, this former mentioned mechanism has enabled *Shari'ah* scholars as well as legal experts to expand the concept of full ownership to include the beneficiary ownership mechanism where the only real owner

is the owner of the usufruct and the seller, who retained the asset, is considered as trustee on the bare. However, it can be said that this mechanism may not be a perfect solution due to the differing legal framework from one country to another.

On the other hand, there is an urgent need to clarify the legal status and the type of ownership to investors before going into any financial transaction as this is dictated by the rules of *Shari'ah*. Additionally, there is an urgent need that selling should be based on the rules of *Shari'ah*, which will result in the protection of investors' rights as well as their ability to dispose of the assets they bought upon the occurrence of any disagreement by liquidated and obtain liquidity.

In this regard, some researchers and *Shari'ah* scholars suggest not relying on the mechanism of beneficiary ownership found in common law as it is originally designed for debt securities in the financial markets. Even if there is a reformulation of the mechanism of beneficiary ownership to be compatible with the *Shari'ah* rules, it is ultimately derived from the common law, which does not take *Shari'ah* rules into account and consequently the risk of none-*Shari'ah* compliance still exists.

However, despite all, Hassan (2011) suggested that based on *maqased al-Shari'ah,* it is preferable that the assets registered and comply with the regulation of the land in order to secure the rights of the *sukuk* holders. In addition, he also suggested that the preservation of the interests of the *sukuk* holders from any kind of risks as well as to evidencing that the legal ownership is preserved can only achieved through the seller by issuing a 'deed of trust and regency' confirming that he will keep the title for the real owners of the assets as he has no right to act without their permission.

The main concern, here, is not only the proving of the validity of the right of the contract or not in *Shari'ah* terms as it has already been mentioned by Hassan (2011). However, the matter is rather associated with the potential legal risks that might encounter *sukuk* holders in relation to affecting their capability to behave as owners with regard to the origin of *sukuk* they have already acquired whether through selling or rent or even being offered as it has been noted by AAOIFI as well as the Islamic *Fiqh* Academy. Ibn Taymiyyah (as stated by Merah, 2011; Almarshood, 2013) considers these constituting real meaning of ownership. Moreover, in proving ownership of the assets in the case of bankruptcy or insolvency of the issuer, the

official register is considered among the requirements of *Shari'ah* that advised by scholars as to avoid conflicts (Al-Sayed, 2013). This is substantiated with the Qur'anic verse (2:282**)** stating that "Oh you who believe you should write down any debts between you for a certain period' in order to maintain the rights of people to avoid conflicts between them".

6.2.3 The Validity of the Underlying *Sukuk* Assets

It could also be argued that one of the critical issues with regard to *sukuk* structure is the real nature of the assets underlying *sukuk* structures. In this regard, Dagi (2011) asserted that some issuances do not represent the real assets, usufruct or services or otherwise rights that can be financially evaluated in the market; rather the underlying *sukuk* indicates that the issuer has sold just the right of obtaining the returns which will be generated from the assets in future or the future profits to be distributed to the *sukuk* holders. However, it should be noticed that selling the right or selling the future right of getting the future financial gains is not considered as selling of the assets, usufruct or services but rather it is considered as selling of the returns of the assets and that should not be allowed in *Shari'ah* terms as it is considered as *riba* (Merah, 2011; Almarshidi, 2014).

It can be argued that the right, which can be sold and bought, is the right which has a financial value and can be assessed such as the privilege rights (Almarshood, 2013). Nonetheless, Merah (2011) argued that many of *sukuk* structures, which are based on rights, cannot be valued and assessed; therefore, it is not considered *Shari'ah* compliant. On the other hand, Merah (2011) believes that there exist some restrictions that must be considered in order to make the '*sukuk* of rights' approved from *Shari'ah* perspective. He states that *sukuk* holders should have full rights of the *sukuk* they hold either through the right of asset or the right of usufruct that can be valued, sold and fully controlled. In addition, the contract should also be targeted itself rather than just for the sake of gaining future profit such as the contracts of *enah* sale.

6.2.4 The Guarantee of the Returns

Given the risks involved from a *Shari'ah* perspective, returns on capital investment cannot be guaranteed, as one of the *Shari'ah* principles states that '*al ghonm bil gorm*', which literally means no reward without taking risks (Askari *al et,*. 2011).

Therefore, AAOIFI's (2010) related standards state that "The prospectus must not include any statement to the effect that the issuer of the certificate guarantees a fixed percentage of profit". In this respect, it could be argued that *sukuk* manager by being committed to pay specific profits based on the benchmark is similar to the commitment of *riba*-bond issuer to pay periodical profit on the nominal value of the bond based on the benchmark (Almarshood, 2013). Consequently, in the case where there is a guarantee of specific profit on *sukuk*, then it will be *sukuk* based on loan with specific profit which features *riba*., and that fact will not be changed whether given the name profit or lease as the case with *ijarah sukuk*, for instance. In relation to this, Hassan (2011) states that it is not allowed for *sukuk* manager to guarantee profit for *sukuk* holders or any other specific return whether that profit for a specific amount or any other percentage from capital or depending on a certain benchmark such as LIBOR. It should be mentioned that all current scholars agree on this principle with no exception.

In addition, it can be said that the reason behind the prohibition of making the securing of the profit as a condition is that such condition terminates the partnership between the two partners, so that the profit will be on the commitment on one partner who has to pay the profit no matter the project has generated profit or loss. As can be seen, this will be the same as *riba* (Hassan, 2011).

It can, therefore, be inferred from the above discussion that the *Shari'ah* has prohibited the predefined interest (profit) whether the interest is based on the capital or according to the benchmark such as LIBOR as it is considered *riba*. However, in the case of *ijarah* structure, what it is fixed in advance is not the profit rather the lease that must be visible and specific at the beginning of the contract as *Shari'ah* rules clarified that as this matter will be explained in details in 6.2.6.

6.2.5 The Distribution of Profits Based on an benchmark

It should be noticed that *sukuk* markets have based their calculation of profits for *sukuk* holders depending on the performance of a certain benchmark such as LIBOR and SAIBOR, as those benchmarks are linked with the prices of loan between banks (Shaatah, 2003). Nonetheless, it should be mentioned that those benchmarks are mainly indicated by being unstable as they differ from one time to another depending

on the availability of cash in the bank and the standard of the currency in the market as being represented by those benchmarks (Habsh, 1998).

As the practice in the markets indicates, the use of interest mechanism such as LIBOR is becoming a common feature that characterise Islamic financial instruments. However, Shaikh and Saeed (2010) pointed out that as the case with conventional bonds, the same pricing reference being used by Islamic banks as an appropriate reference for *sukuk* pricing. This can be attributed to the failure of *Shari'ah* scholars and economists, who have failed to provide an alternative for conventional interest rates, which could be used by Islamic banks and other financial Institutions as a reliable benchmark (Al-Amine, 2008). In this regard, Wilson (2008) argues that the use of alternative benchmark to the LIBOR in Islamic financial instruments and contracts becomes inevitable. However, in reflecting on alternative benchmarks, Wilson (2008) argue that such benchmarking could be based on macroeconomic benchmarks featuring real economic activities such as the Gross Domestic Product (GDP) growth for sovereign *sukuk* as well as firm performance in case of financing corporations. In a response, Almenea (2010) argued that the use of LIBOR as a benchmark is essential as a benchmark at early stages; however, the practice should be dispensed of following substantial developments of Islamic financial institutions.

It could be argued that the main reason behind companies being dependent on the profit benchmarks is that *sukuk* are being considered as a substitute for conventional bonds that are based on benchmarks for defining the level of profits, as the conventional bonds do not based on productive assets as *sukuk* structure. Therefore, as long as *sukuk* are considered as substitute for *riba*-based bonds, those who are working on *sukuk* structures tend to avoid all non-*Shari'ah* compliant elements in the *riba*-based bonds. However, they failed to avoid using the same benchmarks which also used in *riba*-based bonds, given that *sukuk* do the same role of *riba*-based bonds whether investment or funding (Usmani, 2007; Almenea, 2010). It is worth mentioning that those who invest in *sukuk* they always seek to ensure the stability of their profits, which cannot take place without depending on a benchmark through which they can find out the amount of profits that they are going to get from their investment on *sukuk* (Elgari, 2011). For that reason, the industry including the *Shari'ah* scholars tried to work with the *riba*-based bonds benchmark.

6.2.6 Evaluation the Current *Ijarah Sukuk* Structure from *Shari'ah* Perspective

According to Hammad (2003) and Almenea (2011), depending on conventional benchmarks to determine the rent which literally considered as profit associated with the current *ijarah sukuk* structure is against the rule of *Shari'ah*. The rent in *ijarah* structure should be determined and known for both parties at the time of issuing the *ijarah* contract otherwise the transaction will lead to *gharar*, which is prohibited. In other word, since the LIBOR as a benchmark used in *ijarah* is not stable as it has been mentioned earlier by making reference to Habsh (1998) and the rent will be depending on the changeable benchmark such as LIBOR then the rent will be unstable, which as a practice is not allowed according to the *Shari'ah* principals. However, even if *gharar* is allowed in such as case, since there are many other reasons, the transaction will be non-*Shari'ah* compliant according to Hammad (2003), Merah (2008) and Almenea (2011). Therefore, it is still considered against *Shari'ah* rules. The first reason is that, most of *ijarah sukuk*, which are currently available on the market, can be described as a type of disallowed sales in *Shari'ah* terms, namely *enah* sale. In addition, selling such type has more than one method; and the most popular method is that one sells a commodity to another for a deferred price and then he buys the same commodity for a current price for less than the price he has already sold. Another method is what is known as the reversed *enah* featuring one person who sells a certain commodity to another person for a current price and then buys the same commodity for a postponed price at the higher price than the first.

However, the similarity between the reversed *enah* and *ijarah sukuk* structure, which is currently widespread, can be described by the fact that *sukuk* issuer sells an asset for a current price and then latter renowned it back from the buyer for a deferred price to be paid by instalment to *sukuk* holders for more than the current price, while the second sale will be conditioned on the *sukuk* so that asset in between will make no difference. Furthermore, another method is that the *sukuk* issuer sells certain *sukuk* assets for a current price and then hires them from *sukuk* holders for a specific duration during which it gives *sukuk* holders the profits against the rent for *sukuk* and at the end of *ijarah* period the *sukuk* issuer will manage to buy the assets for a nominal price (Merah, 2011; Almarshood, 2013). However, in this regard, Ibn *Taymiyyah* pointed out that the scholars have agreed on disallowing selling *enah* given that the second sale is conditioned in the first contract, meaning that the seller

has to set a condition for the buyer to sell him the commodity that he bought from him for the second time (Ibn Qasem, 1995). It should be noted that *enah* sale is becoming disallowed as it has become an excuse for the use of *riba*, as the asset or the commodity is not a target in itself but rather the money itself is the main target so that the whole process becomes 'money against money' with an untargeted commodity in itself but what is targeted is having a loan with interest (Alroshood, 2013). However, Alshobaili (2011) argued that generally speaking targeting money in any transaction is allowed, as the aim of the business is to gain money unless the transaction is not according to the principle of *Shari'ah.*

The second prevailing reason is that the most of *ijarah sukuk* structures are currently used are based on '*wafaa* sale' which is prohibited in *Shari'ah* (Almenea, 2010). In addition, the meaning of the *wafaa* sale is that when there is an agreement between two persons for a certain assets for instance that the buyer has to pay a certain amount to the seller so that the seller from his part has to offer the buyer an asset to make use of it until the seller returns the money with him to the buyer in order to return the real estate that he has already sold it (Barodei, 2012).

It should be mentioned that the reason for this label as '*wafaa* sale' as the buyer has to become committed for selling the assets again to the seller. In this regard, *ijarah sukuk,* which are similar to *wafaa* sale features the fact that the *sukuk* issuer will sell his asset or the usufruct of the asset to *sukuk* holders and then lease again the asset from *sukuk* holders for a certain period of time so that at the end of that period of lease, the *sukuk* issuer will buy the assets for the second time from *sukuk* holders for the nominal price (Alammar, 2003).

It could be said that the majority of scholars from *Malikis*, *Hanbalis* and *Shafis* are on the believe that *wafaa* sale is disallowed, as that sale mainly targets making *riba* rather than assets and in fact it is really a loan that makes a benefit which is not allowed (Barodei, 2012). In addition, it has also been stated, by the Islamic *Fiqh* Academy's Decision No 66 (4/7), that *bay' al-wafaa* (debt guarantee sale) is "the sale of money on condition that when the seller returns the price, the purchaser returns to him the amount purchased, this sale is in fact a loan which has generated a profit. It is therefore a fraudulent practice of *Riba*, and is considered unsound by the majority of *Ulema*. The Academy considering this contact prohibited in *Shari'ah*". In addition,

Ibn *Taymiyyah* stated that "if the sale is targeting the seller to take the money while the buyer takes the asset to benefit from its rent as long as the money remains with the seller unless he returns the money to buyer then the buyer will returns the asset to the seller then that will be disallowed as it represents a sale of money for the same money in addition to the rent which goes to the one who makes the loan who is actually the buyer" (Ibn Qasem, 1995;198). Such sale is also known as '*amanah* sale' (trust sale), as the asset remains in the trust with the buyer so that he can benefit from its rent until the seller returns its asset. Therefore, Ibn Taymiyyah (as cited by Ibn Qasem, 1995) pointed out that the sale of trust (*amanah*) is also invalid by the agreement of scholars. Moreover, it has been argued that *wafaa* sale or *amanah* sale might be valid by the argument that even though it is inconsistent with *Shari'ah* rules, such sale is approved given that people need it to avoid *riba*; so that it is originally disallowed but it has been approved given the need of people for it (Elgari, 2010). Nonetheless, it has been argued that it will be incorrect to say that the need of people for such kind of transaction should make that sale allowed in terms of *Shari'ah*. Therefore, the Islamic *Fiqh* Academy's Decision No 177(3/19) asserted that *fatawa* issued by SSB's should follow the *Shari'ah* rules and apply that rules rather than depending on transaction with no *Shari'ah* evidence or support but rather it is just tricks and fraud (*heal*).

Furthermore, it should also be stated that among the reasons that make such type of *ijarah sukuk* disallowed is that the above mentioned structure (the selling of *sukuk* by the issuer some of certain assets for a current price and then lease them from *sukuk* holders for certain period of time and during that period he gives *sukuk* holders the lease of assets as returns for *sukuk*, and then at the end of the period of lease, the *sukuk* issuer will buy the assets again for the nominal value) is considered multiple structured by including many contracts and promises, which seems to be unreal, and the transaction is considered as a *ribawi* (Almenea, 2010; Alroshood, 2013).

However, the *sukuk* issuer who is the owner of the usufruct when he sells the usufruct to *sukuk* holders and afterwards rent them from *sukuk* holders by promising to buy the *sukuk* from *sukuk* holders at a certain time, and that during the lease time the issuer (who is currently the renter) will manage to pay the rent in form of returns to *sukuk* holders. Such a mechanism will make the *ijarah sukuk* unreal and not a target itself (Merah, 2008). Therefore, it becomes obvious that the loan is the target for profit and

that becomes consistent with function to be done by the *riba*-based bonds. In other words, *sukuk* holders have given a loan to *sukuk* issuer in the form of money in return for periodical returns (which represents the price of rent) as to be paid by the issuer to *sukuk* holders on that loan. However, Hammad (2003) believes that in the case of collective multiple contracts, even though they might be perfect and valid, when they agree on a disallowed idea or end in something not allowed, then such type of *wafaa* sale will become invalid and disallowed. Consequently, in the above mentioned structure case, it features a valid sale contract with a valid *ijarah* contract and so the two come together aiming at targeting a loan for profit as it has been mentioned above.

In contrast, Abu-Goudah (2003) and Hassan (2003) approved dependence on the LIBOR benchmark to determine the profits associated with *ijarah sukuk*, as the *sukuk* issuer in the *ijarah* contract is considered as seller for the asset itself or the usufruct of the asset to the *sukuk* holders, and then the issuer becomes a hirer so that he leases what he already sold it or hired it to *sukuk* holders for a lease based on the profit price (the benchmark) and the *sukuk* issuer will commit itself to buy *sukuk* at the end of the *ijarah* period.

In this respect, among others Hassan (2003) argue that there is no similarity with the prohibited sale such as *enah* and *wafaa* with the current *ijarah sukuk* structure as the origin in the contracts and the conditions is allowance based on *Shari'ah* principles. In addition, *ijarah sukuk* represents collective contracts (sale contract and *ijarah* contract) and those contracts should fulfil the conditions and they come together in a different mode from that of the loan which is based on interest. Abu-Goudah (1999) and Hassan (2003) explained further that the sale and then the lease and then the sale, in one contract, are in fact do not represent a loan based on interest as there is a huge difference between the loan and *ijarah* with regard to conditions and requirements.

Moreover, Abu-Goudah (1999) and Hassan (2003) believe that in the case of *ijarah sukuk* the lease of the property that will be hired will be known and the rent will be most likely either based on the original price of the asset and making a certain percentage from it so that percentage becomes a price for rent, or otherwise making a certain amount to be agreed upon between the one who rents and the owner. Therefore, depending on a certain benchmark is not a target as it is useless for that

dependence on the benchmark as long as the rent is known and the profits are fixed when the contract has been signed. However, the reason for dependence on any benchmark with regard to *ijarah sukuk* is for fixing the incentive that will go for *sukuk* manager who receives all that in excess of profit on the benchmark. It should be noted that the AAOIFI has approved fixing rent based on a specific benchmark given that it should be fixed in the first stage with a certain numbers and that there is a minimum and maximum limit of the benchmark (Hassan, 2003). In this regard, the decision of the Islamic *Fiqh* Academy's No 188 (3/20) stated under the section of 'Leasing an Asset to the Seller' that "An asset may not be sold at a cash price with the condition that the seller leases this asset as a lease coupled with a promise of ownership at a total of lease and price exceeding the cash price whether this condition is explicit or implicit as this type of sale is considered as enah sale which is prohibited by *Shari'ah*. It is therefore not permissible to issue *Sukuk* on the basis of such a mode".

6.2.7 The Dependence of Investment *Sukuk* (*Musharakah, Mudarabah* and *Wakalah* agency) on a Financial Benchmark from *Shari'ah* Perspective

Usmani (2013), in general, disallowed using a benchmark without distinctions between *Shari'ah* structures. In addition, Hassan (2003) believes that fixing profit should not be allowed no matter depending on the benchmark or depending on specific percentage of the nominal price and any other specific amount. In this regard, hence, there is an agreement among *Shari'ah* scholars on the prohibition of using and depending on a financial benchmark or benchmark with regard to contracts mentioned earlier. This is due to the fact that the holders of investment *sukuk* have to obtain the actual profit to be expected from investment of *sukuk* assets they own no matter that profit being more or less, and in case no profit has been made of the project then *sukuk* holders will not claim any profits as they will be subject to the business risks (Toufahah, 2014).

On the other hand, the reason of depending on the LIBOR benchmark can merely be for a mechanical or technical matter in the sense that the *sukuk* holders will obtain a stable return. If this is the case, then what has been in excess of the specific percentage, it will go to *sukuk* holders and will be kept in the reserve account to face any future risks, such as decline in profit rate as a result of the adverse performance of

the benchmark or the benchmark. However, in case *sukuk* have been sold then whatever goes to reserve account will go to the agent as an incentive, which should be made as a condition that has to be agreed upon by *sukuk* holder (Elgari, 2010).

Nonetheless, regarding the claim of companies that it is being necessary to have a benchmark for companies who issue *sukuk* to depend on with the objective of assuring investors with regard to profits and capital from the project manager as that has already been mentioned above. It could be said that the manager is originally a trustee no matter being a *mudarib* or an agent, thus, the previous CV of *sukuk* manager will tend to encourage investors rather that by giving a guarantee for profit in a way that reverse the reality of contract. In addition, the nature of the project and the studies that have been made will fix the amount of expected profit without the need to a benchmark or benchmark that has been originally made to indicate the price of *riba* profit (Almenea, 2010; Alroshood, 2013).

Moreover, there is nothing wrong in *Shari'ah* term to allow the establishment of specialised economic institutions with high financial solvency as an independent entity from the issuer so that they undertake the economic stability for the projects and estimation of profits expected based on accurate standards and monitoring the real profits. By doing so, those institutions will undertake the function to be undertaken by the institutions of international credits (Alroshood, 2013).

According to Usmani (2007), he indicated that in case when the distribution of investment profits to *sukuk* holders is based on those benchmarks rather being based on the real profit or otherwise the profits have not been linked to the investment activities but rather the percentage of profit is linked to the paid capital for *sukuk* that has been bought, then that will reverse the nature of the contract to *riba* loan contract similar to conventional bonds. In this regard, as it has been mentioned, AAOIFI (2010) stipulated that "the prospectus must not include any statement to the effect that the issuer of the certificate guarantees a fixed percentage of profit". On the other hand, Almenea (2010) suggested that the periodic distribution of profits should be linked to the actual profit to be produced by the investment activity without paying any attention to those benchmarks.

6.2.8 Guarantee of the Capital

Elgari (2009) pointed out that many economists believe that *sukuk* that are not being rated cannot be circulated in the financial market, as the 'credit rating' is the one issued by international rating agencies. Such agencies rate financial performance including *sukuk* according to the credit risks which is considered as the ability of *sukuk* issuer to return the capital to *sukuk* holders and its ability also to secure the specific profits in the prospectus issuance. Elgari (2009) also argued that there is no way of rating the ability of *sukuk* issuer to return the capital money and its security to provide periodic profits to *sukuk* holders, unless the capital is being guaranteed in the form of a loan on *sukuk* issuer's balance sheet. However, in case *sukuk* is based on real assets, usufruct or rights, then *sukuk* issuer will develop certain ruse such as making the capital as a loan on himself in his balance sheet. In addition, they will issue a binding promise agreement to buy those assets, usufruct or rights from *sukuk* holders at its current selling price. Consequently, his promise to return the money capital is considered as a commitment on himself subject to credit rating as it is considered as loan. Therefore, depending on the high classification of the issuer, the investor will be encouraged for investing in *sukuk* (Elgari, 2009).

On the other hand, it could be argued that most *sukuk* contracts issued nowadays indirectly feature guarantees given to *sukuk* holders as managers make an undertaking to buy assets upon *sukuk* maturity for a given value regardless of their current value at the time of maturation (Usmani, 2007). This arrangement could be resemble to conventional as the manager will either be a loser in case of losses or a winner in case of gains, in which case *sukuk* holders will only be entitled to their principal amount. In such a case, that practice is considered as inconsistent with *Shari'ah* principles which prohibit any guarantees given to investors (Almarshidi, 2014). According to *Shari'ah* principles, at the end of the *sukuk* period or when there is intention for sale, *sukuk* holders should be entitled to the current market value of the asset involved (Tariq, 2004). In this regard, Usmani (2007) pointed out that the manager could become a speculator (*mudarib*), partner (*shareek*) or otherwise an investment agent (*wakel*) of potential investors depending on the situation.

The AAOIFI (2010) standards in relation to investment *sukuk* provide that "The prospectus must not include any statement to the effect that the issuer of the certificate

accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts and negligence". In addition, it has been stated by the Islamic *Fiqh* Academy's Resolution No 178(4/19) concerning the *sukuk* and its current application, "the *sukuk* manager is a trustee that should not guarantee the capital except if there is a negligence or dereliction of his duty or otherwise inconsistency with the condition of *musharakah, mudarabah or wakalah* agency with respect to investment". Accordingly, if the prospectus issuance included a statement of the condition featuring the commitment of the issuer or the *sukuk* manager to buy the underlying *sukuk* assets on its nominal value at a specific date, or otherwise the prospectus of issuance refers to the fact that *sukuk* holders should commit to sell their *sukuk*. This, then, will be considered as giving a guarantee of the capital that is not allowed in terms of *Shari'ah* (Merah, 2011). In addition, the Islamic *Fiqh* Academy's Decision No 188 (3/20) states that "No *mudarib*, partner, or agent shall commit to buying *Sukuk* or *Sukuk* assets at their nominal value or with a predetermined value leading to capital guarantee or to current cash for deferred cash, save in cases pertaining to abuse and negligence, which require the guarantee of the rights of *Sukuk* holders". Consequently, it should be mentioned that the guarantee of capital will transfer the process to *riba* transaction due to the fact that *sukuk* holder will receive a profit. However, he will not be considered as guarantor based on the *Shari'ah* rule of '*al ghonm bil gorm*' and that guarantorship will not be allowed by the *Shari'ah* scholars (Abu-Goudah, 1999).

However, in case the prospectus of issuance stated that a commitment of the issuer exists by buying the assets at its market value or a fair value, the in such a case, a different judgment can be made depending on the type of *sukuk* (Alroshood, 2013). Therefore, in case of tradable *sukuk*, such as *musharakah, mudarabah* or *wakalah* agency, the *sukuk* issuer can make a commitment in the prospectus of issuance of *sukuk* to buy whatever given to him by the *sukuk* holders after the process of issuance completed at the market value. As it is stated by AAOIFI (2010) that;

> It is not permissible for the *Mudarib* (investment manager), *sharik* (partner), or *wakil* (agent) to undertake (now) to re-purchase the assets from *Sukuk* holders or from one who holds them, for its nominal value, when the *Sukuk* are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase.

Moreover, the Islamic *Fiqh* Academy's Decision No 178(4/19) regarding *sukuk* and its current application states that *sukuk* should not be returned back at its nominal value but rather should be at its market value or otherwise at the value to be agreed upon at the time of mature. In addition, the Islamic *Fiqh* Academy's Decision No 30(3/4) stated that it is not allowed that the prospectus of issuance to feature a statement that make a commitment for sale, but otherwise it will be allowed the sukuk include promise for sale in which case the sale should only be completed with a new contracted at the estimated value to be made by the experts to the satisfaction of the parties involved.

In this regard, it can be said that in case of partnership between the manager and potential *sukuk* holders, the former is not allowed according to *Shari'ah* rules due to the fact that giving guarantees to the *sukuk* holders on capital returns tend to disrupt the profit sharing agreement between the two parties (Almenea, 2010). In the meantime, as a partner, the manager should not give binding promises to investors to purchase assets at face value. In this respect, Usmani (2007) asserted that allowing managers of Islamic banks to return depositors' investment tends to eliminate the distinction between *sukuk* and conventional deposit accounts.

In addition, in cases where agency (*wakel*) becomes involved any guarantee given by the manager to investors is considered an unlawful practice as it has been stated by the AAOIFI. This should be so for the simple reason that agency or *wakel* features a contract of trust where no guarantees should be given by the investment agent except in cases of negligence (Usmani, 2007). However, this ruling stems from the fact that any guarantees given by the investment agent will render the enterprise into an interest-based loan in the sense of involving *riba* in violation of *Shari'ah* as it has been pointed out by the AAOIFI as well as the Islamic *Fiqh* Academy.

Therefore, it becomes obvious from the above discussion that managers are not allowed to repurchase assets from *sukuk* holders at their face value at *sukuk* maturity. However, managers can repurchase assets at the current market value or otherwise at an agreed value at the time of purchase. Yet, guarantees on capital returns could only be valid in case of negligence on the part of *sukuk* manager by ignoring investors' conditions as it has been issued by AAOIFI (2010) as well as the Islamic *Fiqh* Academy's Decision No 188(3/20).

As regards to the *salam sukuk,* AAOIFI (2010) states that "it is not permissible to trade in *salam* certificates', as they represent loan and yet in case of the *istisnaa sukuk*. Their circulation is allowed in case the money became assets owned by *sukuk* holders during the time of production as AAOIFI (2010) stated that "It is permissible to trade in or redeem *Istisnaa* certificates if the funds have been converted, within the period of the *Istisnaa*, into assets owned by certificate holders".

On the other hand, it could be argued that there is a difference between guaranteeing the capital by *sukuk* manager and between the promises to buy *sukuk* assets at nominal value (Hassan, 2003). In this respect, Hassan (2003) noted that the guarantee that came from the *sukuk* manager include a promise to buy the assets from *sukuk* holders at the nominal value no matter those assets remain as original or have been damaged and so that guarantee with such commitment is not allowed in *Shari'ah* term. However, the allowed promising to buy at the nominal value by the *sukuk* manager is the promise which is based on the fact that buying at the nominal value will not take place unless the assets remain as original as in the first time of purchase without any change or damage.

In contrast, Alkailani (2011) and Almarshidi (2014) argue that the value of the assets could be dropped without any change or damage on those assets depending on the market performance. Hence, despite the fact that the value of the assets has dropped, the *sukuk* manager has a duty to buy with the capital based on the promise given by him to buy at the nominal value. It means that there is no point for the differentiating between the assets being as original or not.

In addition, it could be also noted that among the differences between the guarantee and the promise to buy is that the guarantee of the capital to buy the assets at the nominal value of *sukuk* should require *sukuk* holders have to sell their *sukuk* even if they do not like to sell, while the promise to buy should be a commitment to *sukuk* manager to buy but is not a commitment for the *sukuk* holders to sell (Hassan, 2003). However, that difference can be rejected by the fact that *sukuk* holders are forced indirectly to sell their *sukuk* at the specific time (five years normally) by *sukuk* manager so that the nominal value of their *sukuk* does not drop after five years. Thus, fixing a date by the *sukuk* manager with the returning of the capital means that forcing

the *sukuk* holder to sell after five years because of the fear of losing the capital (Merah, 2011). Therefore, it can be argued that no difference exists between the guarantee and promise to buy at the nominal value according to the argument discussed early based on the current implications of *sukuk*. In addition, according AAOIFI (2010), Alroshood (2013) as well as the Islamic *Fiqh* Academy Decision No 178(4/19) and 188(3/20), it can be concluded that it is permissible for *sukuk* manager to promise to buy the *sukuk* at the following conditions;

(i) The promise should feature the tradable *sukuk*;

(ii) The promise should be given by *sukuk* issuer by buying what even on offer of *sukuk* by *sukuk* holders and that no promise should be given or commitment on *sukuk* holders to sell *sukuk* to the *sukuk* issuer;

(iii) The purchase of *sukuk* should be based on the market value or what they agree upon at the time of selling;

(iv) The purchase should take place after completing the process of issuance;

(v) The promise to buy by the issuer should not include any commitment of *sukuk* holder to sell for *sukuk* issuer whether that is directly or indirectly such as promise to buy when it is linked to a specific date (such as making the issuer to say that he will buy the *sukuk* at a certain time). Thus, in case that is associated with a fixed date that will make one to understand that *sukuk* holders will be committed to sell their *sukuk* to the issuer at that date. In such a case, the failure to sell *sukuk* will make the value of *sukuk* drop, which will create an advantage to *sukuk* holders to sell their *sukuk* at the time to be fixed by *sukuk* issuer. In other words, linking the promise of purchase to a specific date will cause *sukuk* holders to initiate his proposal for selling before that date and that will lead to the same result regarding setting a condition for the *sukuk* holder to sell his *sukuk.* In this regard, Al-Qarafi (2003) stated that ' *al-wasa'el laha ahkam al-maqasedt*' which implies that the methods will take the same rules as the aims so that if the aim is to commit the *sukuk* holder to sell, then the method that leads to that aim by fixing the date of buying will include the same rule which disallowance. In this respect, the Islamic *Fiqh* Academy Decision No 188(3/20) stated that "contracts should be free from fraud and sham (*heal*) and insuring that they will ultimately guarantee safety from the *Shari'ah* point of view".

In addition, it could be argued that another reason behind the prohibition of the prospectus of issuance which contains a commitment made upon *sukuk* holder to sell

by fixing a specific date is that such a contract is considered as two sales in one which is prohibited based on *Shari'ah* rules (Hammad, 2003). In this regard, Prophet Muhammad (may peace be upon Him) disallowed to make two sales in one sale. In addition, it has been stated that if two people made two sales in one sale contract, then both the sales are invalid as it is based on the intention that 'I sell you as well as you sell me' as a condition (Alroshood, 2013). This is due to the fact that making the sale transaction depends on the condition that 'I sell you in a condition you sell me' will make the ownership unstable as in the case the buyer did not fulfil his promise what will happen to the first sale. In other words, the real ownership does not exist unless the buyer sells what he has promised. Similarly, when there is a promise from the *sukuk* issuer to buy at the face value (after five years as the most of prospectuses stipulate) that will force the *sukuk* holders indirect way to sell their *sukuk* as the transaction will based on the arrangement that 'I will sell you now and you should sell me after five years'. However, the transaction made through the way of promise to avoid the prohibition of making two sales in one will not change the reality as the *sukuk* holders will sell their *sukuk* because they want to obtain their capital back (Merah, 2011; Alroshood, 2013). Nonetheless, it should be mentioned that it is possible to avoid the promise of the issuer or the manager of *sukuk* to buy the assets at the nominal value through many legal ways in order to protect the assets against risks, as discussed below;

(i) *Guarantee from the third party*

It could be argued that among the methods of protection of capital is commitment to be made by a third party to provide guarantee to the capital or the profit in favour of *sukuk* holders (Elgari, 2003; Lahsasna and Lin, 2012). That guarantee, however, can be expected from government officials in case the *sukuk* have been issued in favour of projects to benefit the public (Mshaal, 2012). In addition, it has been indicated by the AAOIFI (2010) that "it is permitted to an independent third party to provide a guarantee free of charge".

Moreover, Islamic *Fiqh* Academy's Decision No 30(5/4) in relation to *mudarabah* and investment bonds states that "there is nothing wrong in terms of *Shari'ah* to provide in prospectus issuance a promise of a third party which is separate in terms of identity and financial independence from the two parties of the contract to provide a

service without pay to cover any lose in any specific project, however, the commitment should be independent from the contract so that in case the third party fails to its commitment the contract will not be affected".

According to the forgoing, it could be concluded that for the third party to give a guarantee, a number of conditions are needed as follows:

(a) The third party should be independent from *sukuk* issuer as well as *sukuk* holders according to the decision of the Islamic *Fiqh* Academy's Decision No 30(4/5) and decision No 188(3/20). In addition, the independence of the third party should be financially ensured and neither the third party is owned by the issuer in full or by the majority of shares according to the Islamic *Fiqh* Academy's Decision No 30 (4/5) (Mshaal, 2012). In this regard, Merah (2011) asserted that the third party should not be as SPV, which has been established by the issuer or that the third party represents one of the companies of the issuer or otherwise the third party represents the state which will guarantee one of the issuances of its ministries or its government departments otherwise the guarantee becomes invalid;

(b) In addition, the guarantee should be for free. In this respect, Alshobaili (2011) states that the guarantee with fees should be considered as a form of commercial insurance as the third party will be committed to pay any loss return for the pay that will be paid to him by the manager or *sukuk* holders and this process is not *Shari'ah* compliant according to Islamic *Fiqh* Academy as it constitutes part of prohibited commercial insurance. In contrast, Elgari (2010) argue that it is difficult to apply those conditions above in the financial transactions that aim for profit and that is what has been indicated by the decision of the Islamic *Fiqh* Academy No 118(3/20), which has not been applied due to the strict conditions included in the decision.

(ii) The reserve profits

Among the methods to protect capital is the allocation of reserve from *sukuk* returns so as to cover the future potential losses (Ahmed, 2011). It should be noted that AAOIFI (2010) identified the reserve as being a certain amount taken out from profits to achieve specific aims. In addition, Islamic *Fiqh* Academy's Decision No 188(3/20) in relation to *sukuk* states that "hedging measures may be taken against *Sukuk* capital and other risks through cooperative insurance and *takaful* insurance which are

governed by the rules of the *Shari'ah*". Furthermore, it has been stated by AAOIFI (2010) regarding investment *sukuk* that;

> It is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk, of mitigating fluctuation of distributable profits (profit equalization reserve), such as establishing an Islamic insurance fund with contributions of certificate holders, or by participating in Insurance (*Takaful*) by payment of premiums from the income of the shares of *Sukuk* holders or through donations (*tabarru'at*) made by the *Sukuk* holders.

On the other hand, it should be mentioned that the establishment of reserve accounts constitutes one of the methods to be used to deal with all risks associated with *sukuk* aiming at keeping a certain level of *sukuk* returns (Duaabah, 2010). It is most likely that the issuance prospectus of *sukuk* includes statements indicating that some amount will be cut in excess of certain percentage of profits to be kept in a reserve account in favour to face keeping the level of profits indicated by the issuance prospectus (Toufahah, 2014).

Nonetheless, the decision of the Islamic *Fiqh* Academy has failed to explain where those reserves should go at the end of the *sukuk* period. According to Alanazi (2011), given that those reserves have been deducted against the shares of *sukuk* holders so that share should go back to them when *sukuk* expires. However, in case *sukuk* holders have sold their underlying *sukuk* assets before their *sukuk* expire, then whatever their shares they have in the reserve account either they give it up optionally in favour of other *sukuk* holders based on what it called in *fiqh* as *ibra'a*. The meaning of *ibra'a* is that the investors who sold their *sukuk* should give up their rights of their profits in the reserve account to others, or otherwise those reserves should go to charity organisations under the control of *Shari'ah* committee members of the bank and that after taking consent *sukuk* holders who are the owners of those reserves (Dagi, 2011). By contrast, Alanazi (2011) argues that it is preferable that the money should go back to the owners, which according to an accounting point of view will not be difficult given the methods of modern technology.

6.2.9 The Deduction of Reserves from *Shari'ah* Perspective

It could be argued that one of the critical issues that can be taken against the reserves is deducting reserve amounts for more than is really required. In this regard, it has been stated by the AAOIFI (2010) Standard No 11 that "the reserve of the rate of the

profits is measured by the amount thought by the management as necessary". Therefore, the estimation of the reserve amount is a matter for the management department to decide and yet one of the setbacks of the management is that it approves amounts not based on real studies as those reserves will go to the management as a bonus (Alanazi, 2011).

In this regard, Alanazi (2011) pointed out that the condition associated with the incentive has most likely come from *sukuk* manager and that amount of reserves to be charged against profits will also be decided by *sukuk* manager. Therefore, it could be argued that there will be a conflict of interest as there is nothing that disallow *sukuk* manager to fix a huge amount of reserves to face risks and there might be some sort of believe that such risks might not take place and yet given that at the end of the period he makes use of those reserves as a bonus, the *sukuk* manager, then, manages to increase the amount of those reserves to get benefit of them. In other words, the *sukuk* manager or issuer is the one who decides the amount of reserves and hence he will be the one who benefits from those reserves as a bonus. For this reason, the scholars have disallowed the agent to buy the goods that have been given to them to sell them on behalf of the seller.

6.2.10 The Condition set by the *Sukuk* Issuer to Benefit of the Reserve Account

Observation and examination would show that a number of issuance prospectus stated that the *sukuk* manager has got the right to benefit from amounts available in the reserve account with the guarantee given. However, this cannot be allowed, as it is considered as a loan from *sukuk* holders to *sukuk* manager. In addition, this will constitute a combination of sale and loan in one contract, which is not *Shari'ah* compliant, as Prophet Muhammad (pease be upon Him) prohibited the transaction of combining sale with loan (Alshobaili, 2011). However, Alanazi (2011) suggested that instead of giving loan, the *sukuk* issuer or manager should invest whatever is available in the reserve account in favour of *sukuk* holders and through a *mudarabah* contract the two sides will agree on a percentage of profit between them. In addition, Alshobaili (2011) also suggested that the reserves should go to Islamic accounts independent of the account of the issuer so that the issuer does not benefit from it.

6.2.11 The Condition of a Loan When the Profit Becomes Less than a Specific Percentage

Sukuk manager will be normally committed to offer a loan without interest to *sukuk* holders in order to guarantee a distribution of a specific return to *sukuk* holders at fixed dates. In this, loan is made when no profit is made from the project or that the profits comes less than amount as stated in the prospectus issuance.

In this regard, Almarshidi (2014) pointed out that in case the loan given by *sukuk* manager will be paid back then that action will be allowed, as the manager will be paid back his loan of the profits he got from coming periods, and if there is no profits he will get that back from *sukuk* assets when *sukuk* expire. However, in case the loan is not paid then that will be not *Shari'ah* compliant, as such a practice is not allowed by the consensus of the *Shari'ah* scholars due to the fact that this provides a guarantee for profit. However, since the profit at the time of contract is not available, they cannot guarantee something unavailable (profit) and cannot be given (Alshobaili, 2011). In addition, according to Usmani (2007), providing loan without any condition to get it back is not allowed, as it brings together selling and giving loan.

On the other hand, when profits turn out to be lesser than the fixed percentage, the promise from the manager for giving loan to the *sukuk* holders will most likely be in return for *sukuk* holders for giving up their profits if they exceed the fixed percentage in favour of the manager and the issuer (Merah, 2011). Consequently, according to *Shari'ah* rules, such a practice is not allowed, as it has got loan and sale that comes together in one contract, which is prohibited due to having a combination of sale and loan in one contract, and every loan that makes a profit is considered as a *riba*. Moreover, it should be mentioned that the Islamic *Fiqh* Academy's Decision No 178(4/19) in relation to *sukuk* states that "it is not allowed for *sukuk* manager to promise to lend *sukuk* holders or give free donation to make up for the real profit which is less than expected profit". Furthermore, the Islamic *Fiqh* Academy's Decision No 188(3/20) also stated that "lending to *Sukuk* holders when the real return on *Sukuk* falls below the projected return thus leading to borrowing and selling or obtaining loans with interest. A reserve may be created from profits to cover potential shortfalls".

By contrast, according to Almarshidi (2014), some believe that the disallowance of promise is related to do with investment *sukuk* (*musharakah, mudarabah and wakalah*). In such *sukuk* cases, it is not allowed for *sukuk* manager (being a *mudarib, shareek* or *wakeel*) to commit to give a loan to *sukuk* holders in case insufficient *sukuk* assets returns compared to the fixed return as indicated by the prospectus of issuance. Such a case can lead to a combination contract bringing sale and loan together in one contract which is disallowed as being similar to *riba.* Nonetheless, for funding *sukuk,* such as *sukuk al-manfa'a* or *sukuk al-hughog* (rights' *sukuk),* it is allowed for *sukuk* manager to give a loan to *sukuk* holders in case the returns comes out to be less. This is due to the fact that *sukuk* manager is considered as an independent third party, but on condition that promise remains independent and is not associated with condition in the contract. In addition, as has been stated by AAOIFI (2010), "It is not permissible for the Manager of *Sukuk*, whether the manager acts as *Mudarib* (investment manager), or *Shareek* (partner), or *Wakeel* (agent) for investment, to undertake to offer loans to *Sukuk* holders, when actual earnings fall short of expected earnings".

On the other hand, in case the loan given by *sukuk* manager to guarantee a distribution of a specific return to *sukuk* holders at fixed dates that will not be paid back as it is considered as a donation from the manager of *sukuk* to *sukuk* holder then that transaction will be prohibited as it is considered as a guarantee for the return (Alshobaili, 2011). In this regard, Almarshidi (2014) also argued that it is not allowed to provide a non-refundable loan to *sukuk* holders as the issuer is considered as a trustee and the trustee cannot be guarantor unless if there is any negligence from the issuer.

6.2.12 The Condition of Incentive for the *Sukuk* Manager

It should be mentioned that the incentive is the condition to be paid to the manager of *sukuk* for his good performance in addition to what is given for him as indicated by the prospectus of issuance (Alshobaili, 2011). In addition, in most *sukuk* issuances, the condition is normally set by the issuer that in case he discovers an excess of the reserve account at the end of the *sukuk* period amounts more than the expected rate to be made for periodic distributions as indicated by the prospectus of issuance, then he

has the right to take whatever is excess into the reserve account as bonus for his good performance (Almenea, 2010).

However, according to Alzuohaili (2000) and Almasrei (2000), such a condition invalid for a number of reasons. The first reason is that such a condition will lead to the termination of profit sharing between the *sukuk* manager and *sukuk* holders. In addition, the amount of profit in excess of the fixed percentage as referred to by issuance prospectus is unknown. Furthermore, the incentive is considered from *Shari'ah* perspective as an *ujrah* (wage) so that the condition of *ujrah* should be known. Moreover, it could be argued that such condition will make the contract not real, as the profits are usually based on the conventional benchmark. As a consequence, in case the manager takes whatever becomes excess of the expected of the profits, then the process will converge towards conventional bonds. This is due to the fact that bonds holders have only a certain percentage as fixed in the bond and anything in excess of the benchmark from the profit should go to the bonds manager. Furthermore, among the reasons that make such a situation to be disallowed is that *musharakah* and *mudarabah sukuk* make both two parties share the profit and loss. Such a condition for bonus should not be consistent with contract given that no sharing will be on profit, as the profit will go to the *sukuk* issuer or *sukuk* manager and the condition, as a result, will be invalid.

By contrast, Aldareer (1993) and Alshobaili (2011) believe that the *sukuk* manager will be allowed to set such condition according to Ibn Abbas, as Ibn Abbas stated that "it has allowed for somebody to ask another to sell a shirt on behalf of him for a specific price and yet what is in excess of that it is for the seller as an incentive". In addition, it could be argued that from *Shari'ah* principles, whatever has been said by the *Sahabah* will be considered as a judgment unless there has been a proof based on *Shari'ah* to argue against that; hence, this maxim is valid for Ibn Abbas' statement (Alshobaili, 2011). Moreover, the bonus does not terminate the share of profits as the manager will share the profits with *sukuk* holders to a certain limit and then will take what comes as excess. This evidences that there will be an initial share, which does not make that contract invalid, as long there is a share. In addition, the validity is also provided by *Shari'ah,* as there is nothing in *Qur'an* or the *Sunnah* making the condition of incentive not *Shari'ah* compliant. As *Qur'an* (*Surat Al-nisa'a*, *Ayah*, 29)

states that “Oh you who believe you should not try to take other people’s money without good reason unless it is a trade agreed between you”. Therefore, Almighty Allah puts the agreement as a condition in case of trade. Thus, when an agreement takes place and nothing else in *Shari’ah* that indicates invalidity then the contract will be valid, and also an hadith states that “the Muslims are upon their conditions” (Alshobaili, 2011).

However, according to Usmani (2007), there are some details in the condition of the incentive: if there is any kind of fixation of the *ujrah* for the *sukuk* manager and that any excess will be a bonus for the manager that will be allowed by the most of scholars as there is no denial of wages and whatever comes in excess of the wage will go as a bonus for the manager of *sukuk* for his good performance. This is supported by AAOIFI’s (2010) in *Mudarabah* Standard No. 13 states that

> If one of the parties stipulates that he should receive a lump sum of money, the *Mudarabah* contract shall be void. This rule does not apply to a situation where the parties agree that if the profit is over a particular ceiling then one of the parties will take the additional profit and if the profit is below or equal to the amount of the ceiling the distribution of profit will be in accordance with their agreement.

On the other hand, Usmani (2007) believes in the invalidity of the current applications of the *sukuk* structures with regard to the fixation of the distribution of profits and the way they work out the incentive for *sukuk* manager. In this regard, he referred to the fact that according to many scholars who approved that the manager of *sukuk* has to take whatever comes in excess of a specific percentage of the profits as a bonus to him for his good performance. This is due to the fact that they are allowed the excess based on the fact that the incentive will be based on the expected profits of the project that are based on real studies of the project and not to fix the bonus based on profit benchmarks of *riba* as is being made now in many *sukuk* structures. For that reason, Usmani (2007) and Almenea (2010) believes that the bonus featuring current *sukuk* structures is not a real bonus but rather is a result of making *sukuk* mimicking *riba* bonds to fix a certain amount of profits for *sukuk* holders according to an benchmark or benchmark and not based on the real profits of the project and what comes as an excess of profits goes to *sukuk* manager.

Accordingly, Almenea (2010) argued that the *sukuk* manager has no right to take anything more than what has been fixed for him by the prospectus of issuance. In

addition, the *sukuk* manager has the right to take a reasonable percentage of the profits by the consent of *sukuk* holders, as the *sukuk* manager takes a share that has been fixed for him by the prospectus of issuance. Therefore, he has no right in the profits of the excess expected percentage, which should go to the *sukuk* holders. According to Merah (2008), the incentive agreement made between the *sukuk* manager and *sukuk* holder was not based on an agreement from the *sukuk* holders but it was set as a precondition for *sukuk* holders that the bonus should be owned by the *sukuk* manager and that *sukuk* holders have no option to reject that condition.

In addition, Elgari (2011) asserted that the *sukuk* manager has no right to set a condition for *sukuk* holders featuring prospectus issuance as to give up the right in relation to the amount of money available in the reserve account at the end of the *sukuk* period. However, in case *sukuk* holders have received whatever amount in the reserve account and they have the ability and full control of the amount in the reserve account, then there is nothing wrong according to *Shari'ah* to allow them to give what they have received to the *sukuk* manager as an incentive.

On the other hand, it should be noted from the *maqased al-Shari'ah* point of view, the incentive system with regard to *sukuk* structures that are widespread today has not been in favour of the high moral code aiming at the distribution of wealth among investors based on fair system. This is partly due to the fact that *sukuk* structures which are available that are based on the bonus system has made the profit based on the interest rate not on the real profit of the project and so that makes one party take advantage of the other (Usmani, 2007). In this regard, the Islamic *Fiqh* Academy's Decision No 188(3/20) stated that "Islamic *sukuk* should achieve the *maqased al-Shari'ah* in terms of developing and supporting real activities and the administration of justice among people".

6.2.13 CONCLUSION

The discussion in the preceding section is summarised in a systematic manner by presenting the results of the evaluation points in examining *sukuk* structures based on the literature review presented, which as follows:

(i) *The validity of the structure*: the structure should not be like *enah* or *wafaa* structure or other structure, which resembles to bonds structures;

(ii) *The real nature of the ownership*: *sukuk* have to represent the right of ownership no matter being ownership of properties, usufructs or services *etc.*;

(iii) *The validity of the underlying sukuk assets*: Some issuances do not represent the real assets, usufruct or services or otherwise rights that can be financially assessed and evaluated in the market;

(iv) *The guarantee of the returns*: The prospectus must not include any statement to the effect that the issuer guarantees a fixed percentage of profit;

(v) *The distribution of profits based on the benchmark*: The periodic distribution of profits should be linked to the actual profit to be produced by the investment activity;

(vi) *The guarantee of the capital*: The prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts and negligence;

(vii) *The promise of purchase: Sukuk* managers are not allowed to repurchase assets from *sukuk* holders for their face value at *sukuk* maturity. However, managers can repurchase assets at the current market value or otherwise at an agreed value at the time of purchase;

(viii) *The guarantee from the third party*: The third party should be separate in terms of identity and financial independence from the two parties of the contract and the guarantee should be also for free;

(ix) *The reserves profits*: Reserves should go at the end of the *sukuk* period to *sukuk* holders as they are the owners;

(x) *The deducting of reserves*: *Sukuk* should be based on real study and evaluation;

(xi) *The condition set by sukuk issuer to benefit from the reserve account*: All the money in the reserve account should be benefited for the favour of *sukuk* holders;

(xii) *The condition of a loan when the profit becomes less than a specific percentage*: It is not permissible for the manager of *sukuk*, whether the manager acts as *mudarib* (investment manager), or *shareek* (partner), or *wakeel* (agent) for investment, to undertake to offer loans to *sukuk* holders, when actual earnings fall short of expected earnings.

6.3 PERSPECTIVES OF THE SBSS MEMBERS ON THE STRUCTURE OF SABIC *SUKUK*: INTERVIEW ANALYSIS

This section aims to present and discuss the position, opinions and understandings of the members of the *Shari'ah* board of SABIC *sukuk* (SBSS) with regard to the issues related to the structure of SABIC *sukuk*, as SABIC is the empirical case in this study. Each section in the following discussion relates to a particular issue, in which the opinions and understandings of the interviewed *Shari'ah* scholars as part of SBSS are reported.

6.3.1 The Structure of SABIC *Sukuk*

This section presents a discussion based on the opinions and understandings of the interviews in relation to SABIC *sukuk* structure.

6.3.1.1 *Questioning the nature of the SABIC sukuk contract*

According to the Interviewee 6 (first member of the SBSS), SABIC Company has issued three types of *sukuk* all of which have the same structure known as *manfa'ah sukuk* (usufructs *sukuk*). Interviewee 6 identified the term *manfa'ah* or usufruct as the benefit of the sale, as SABIC undertakes the marketing of the products of subsidiary companies. However, SABIC undertakes the marketing of the products of those companies, and in return takes fees and commission for the service. Thus, SABIC has opted to sell that privilege, featuring the right of marketing the products of subsidiary companies to *sukuk* holders. For that reason, SABIC *sukuk* are given the name '*manfa'ah sukuk*' or usufruct *sukuk*. In addition, it has been asserted by Interviewee 6 that it is imperative that the name of the contract should be mentioned in the issuance prospectus.

On the other hand, he pointed out that the initial structure that has been presented to the SBSS has been inconsistent with *Shari'ah* principles and in fact the structure from every aspect can be described as misleading being used as a trick to change traditional

bonds to *sukuk.* Moreover, he argued that the initial structure can be described as *riba*-based structure rather than *Shari'ah*-based *sukuk* structure. Eventually, SBSS has discovered the trick and SBSS have managed to introduce the necessary amendments so that all issuances of SABIC *sukuk* (one, two and three) have become *Shari'ah* compliant according to the Interviewee 6.

According to the Interviewee 7 (second member of the SBSS), the SABIC Company has the right of marketing the products of its subsidiary companies, as he maintained that right by virtue of its competitiveness even though it has no shares in some of those companies. However, SABIC sold those rights of marketing to *sukuk* holders. Accordingly, SABIC *sukuk* could be given the name the '*sukuk* of rights' or 'rights of privilege' (concession).

In addition, Interviewee 7 confirmed that it is essential to mention the name of the contract between SABIC and *sukuk* holders pointing out that mentioning the subject of the contract is even more important. He also suggested that where *sukuk* is involved, there is always something to be sold to *sukuk* holders. However, in case of SABIC *sukuk* what is to be sold is the right of marketing known as the 'privilege right', which labels SABIC *sukuk* as 'marketing rights *sukuk'*.

However, according to the Interviewee 8 (third member of SBSS), SABIC *sukuk* has something to do with leasing rather than selling of *manfa'ah* (usufruct). As a matter of fact, contracts featuring the selling of usufructs are non-existent in *Shari'ah* but rather leasing contracts, as the selling of usufruct is known as leasing. In other words, in *Shari'ah,* the term 'sale' defines the selling of assets, while the term '*ijarah*' defines the selling of usufruct. Accordingly, those who perceive SABIC company as having sold a *manfa'ah* are wrong and their understanding of Islamic contracts should be questionable. In addition, those who believe what has been sold to *sukuk* holders are privilege of rights is also wrong, and that SABIC *sukuk* has to be labelled as a 'marketing *sukuk'.* In fact, SABIC has not sold anything but has leased its right for marketing the products of its subsidiary companies to *sukuk* holders. Therefore, contrary to the belief of those who do not understand the idea of *sukuk,* SABIC has leased rather than sold the rights and obligations of the marketing contracts to *sukuk* holders. In reflecting, Interviewee 8 has been in support of the rest of the members of

the SBSS with regard to the idea that it is fundamental that the name of the contract should be mentioned in the issuance prospectus.

In reflecting on the discussion of interviewee analysis, the following conclusions can be drawn:

(i) SABIC has made three issuances of *sukuk*;

(ii) The members of SBSS are divided with regard to the description of SABIC *sukuk* structure;

(iii) Regarding the first issuance, it became obvious to the SBSS that those who had been involved in the structuring process had intended to mislead the SBSS through structuring SABIC *sukuk* in a manner that made it look very similar to the structure of *riba*-based bonds, and by doing so, they meant to cheat customers by changing names from bonds to *sukuk*.

(iv) All the members of SBSS have agreed that it is important the name of the contract should feature in the prospectus of issuance of SABIC *sukuk*.

6.3.1.2 The differences between SABIC *sukuk* and SABIC bonds

In responding to the differences between SABIC *sukuk* and SABIC bonds, Interviewee 6 argued that SABIC bonds that had been issued prior to the *sukuk* should not have been allowed as they were based on *ribawi* transaction, and the amounts paid by investors to SABIC should, in reality, be considered as debts. Consequently, the relationship should be described as a borrower-lender relationship, according to which SABIC should pay periodic *riba* on those debts. This implies that the bond holder will return his capital back when the expiry date is due. By contrast, with regard to *sukuk* holders, they are different to bond holders as in the case of *sukuk*, the investor purchases assets or usufructs, so that the relationship between SABIC company and *sukuk* holders can be described as a buyer-seller relationship. It follows that *sukuk* holders have the right of selling their *sukuk* with a profit of 10% for instance, to a third party as they are considered the owners of the usufructs. However, selling the bonds is unlawful according to *Shari'ah* principles as they represent money rather than assets.

On the other hand, Interviewee 7 pointed out that those who are not aware of the nature of *sukuk* could be in a state of confusion. In this regard, he mentioned that some might deem *sukuk* as being similar to bonds regarding the profit generated to holders of either of them, as bond holders are given a specific percentage of the value of their bonds. So is the case with SABIC *sukuk* holders, as they are being paid fixed periodic returns, and that makes them similar to *riba*-based bonds. He, however, stated that in case of *sukuk,* the returns are the outcome a commercial process, and that the stability of *sukuk* returns is a matter that has to do with the organisation made by the companies involved to keep good control of liquidity.

In addition to the above argument, interviewee 8 added that one of the most important differences between SABIC *sukuk* and SABIC bonds is that, the latter are guaranteed by the issuer as bond holders will surely be paid back their capital when the expiry date of the bond is due, while no guarantee is given to *sukuk* holders, instead, profit and loss will be existed and *sukuk* holders will bear the risk of loss.

Reflecting on the above discussed responses of *Shari'ah* board members to the above questions, the following conclusion can be drawn;

(i) There is an agreement from all members of the SBSS that the main differences between SABIC bonds and SABIC *sukuk* are;

> (a) In the case of *sukuk,* the relationship between SABIC company and *sukuk* holders can be described as a buyer-seller relationship whereas in bonds, the relationship should be described as a borrower-lender relationship;
>
> (b) In SABIC *sukuk,* there is no guarantee to the capital, while in SABIC bonds the capital that were paid from bonds holders to SABIC is guaranteed when it is due. In other words, bonds holders will not bear any risks as their money will be back in the time of expiry contract. By contract, *sukuk* holders will share the loss and profit;
>
> (c) In SABIC *sukuk,* the returns of the *sukuk* are not guaranteed as it depends on the performing of the assets underling *sukuk,* whereas in SABIC bonds there is a fixed percentage of profits based on the capital.

(ii) In response to those who argue that SABIC *sukuk* is similar to *riba*-based bonds; one of the members of *Shari'ah* board has made a distinction between the regular constant returns given to *sukuk* holders and those given to bond holders.

6.3.1.3 The financial commitments between SABIC and its subsidiaries

This section focused on exploring the views of the *Shari'ah* scholars on the separation and isolation in the financial commitments (financial disclosure), between SABIC and its subsidiaries; and whether that should become a requirement or not. In this regard, Interviewee 6 made it clear that such a distinction between the financial commitment of SABIC company and its subsidiaries is imperative. However, according to Interviewee 6, what is written in the financial records of SABIC company considering the underlying of SABIC *sukuk* as debts should be considered as a mistake made by SABIC company which has nothing to do with *sukuk* that have already been sold to *sukuk* holders. In his view, SABIC has a duty to write off the value of *sukuk* that have been sold from its financial records. Moreover, *sukuk* holders have nothing to do with SABIC malpractices regarding its financial records. That is for the simple reason that *sukuk* holders are the only beneficiaries from the marketing of the products of SABIC subsidiary companies as dictated by the *sukuk* contracts they hold.

As for Interviewee 7, he argued that a distinction of financial commitments between SABIC and its subsidiary companies actually exists due to the fact that even though those companies could be partially affiliated to SABIC, and yet SABIC could have owned some shares in those companies. Therefore, as long as those companies are not fully owned by SABIC, that should imply a distinction between SABIC and its subsidiary companies in terms of accounting and annual budgets. However, the fact that whether SABIC refers to *sukuk* in its financial records as debts or they keep the assets in the financial records as their assets should not affect the ownership of *sukuk* holders to their assets.

However, Interviewee 8 suggested that the real practice should be the main concern rather than what would be written in the books and financial records. In other words, the fact that SABIC refers to *sukuk* value in its financial records as debts should be deemed as an accounting error, given that the accountants have no experience in *Shari'ah* matters. However, in case that happens, it will not be a problem as the real practice is more important than what is written in the books and the financial records.

In critically reflecting on the responses delivered by the members of SBSS in this section, the following conclusions can be developed:

(i) It is important to determine matters in relation to financial commitments between SABIC and its subsidiary companies and that every company should have its financial statements records;

(ii) The members of SBSS have been divided as to whether SABIC has the right to include the *sukuk* in its financial records as debts. Some believe that it is a wrong procedure and that SABIC has no right to do that, while others argue that such procedure does not affect the validity of SABIC *sukuk* as well as should not be associated with any risks in *Shari'ah* or legal terms.

6.3.1.4 The real sharing of profits and losses between *sukuk* holders and *sukuk* issuer (SABIC)

In examining the share of profits and losses between *sukuk* holders and *sukuk* issuer, namely SABIC, both the Interviewee 6 and Interviewee 8 argued that profits and losses should be shared between *sukuk* holders and SABIC, which would constitute the basis for Islamic transactions in line with *Shari'ah* principles. In this regard, Interviewee 6 asserted that, failure of the two parties to share profits and losses tends to render the commercial practice involved as being *Shari'ah* non-compliant. Interviewee 7, on the other hand, argued that it is the type of *sukuk* contract that makes the difference. Therefore, taking this viewpoint into account implies that sharing of profits and losses should only feature *musharakah* contracts rather than *ijarah* contracts. The same could be said about *murabahah* and *mudarabah* contracts, which are common these days, as in case of *murabahah*, there should be no sharing of profit or loss.

Furthermore, on discussing the nature of the SABIC *sukuk*, all the interviewees, namely Interviewee 6, 7 and 8, asserted that there is a sharing of profits and losses between SABIC company as (*wakeel*) not as an issuer and *sukuk* holders. In this regard, the *sukuk* holders will bear risks as there is no guarantee for the capital.

In reflecting on the responses of the members of SBSSs, the following conclusions are drawn:

(i) Two of the members of SBSS explained that sharing the profit and loss is one of the basic rules of business transactions for *Shari'ah* compliancy, while the Interviewee 8 adds that the process of sharing profit or loss varies from one contract to another.

(ii) Two of the members of SBSS argued that SABIC *sukuk* feature the sharing of gain and loss between SABIC as agent and *sukuk* holders whereas Interviewee 8 has argued that sharing profit or loss depends on the type of contract. Yet, in case of SABIC *sukuk* the type of contract has not been explained.

6.3.2 The Assets of SABIC *Sukuk*

This section aims to report and discuss the position of the sampled SBSS members with regard to the issues related to the nature of the assets of SABIC *sukuk*.

6.3.2.1 The nature of the assets of SABIC *sukuk*

In exploring the issues regarding the nature of the assets of SABIC *sukuk*, Interviewee 6 (first member of the interviewed SBSS) mentioned that the assets of SABIC *sukuk* represented the commission offered to SABIC in return for the efforts made by SABIC regarding the marketing of the products of its subsidiary companies. In the construct, that commission was considered to have the sole ownership of SABIC, and that SABIC preferred to sell it to investors. In other words, the assets of SABIC *sukuk* represented the benefit of the concession given to SABIC for marketing the products of its subsidiary companies, and that benefit will be the assets of SABIC *sukuk*.

However, the Interviewee 6 noted that the assets of SABIC *sukuk* are the marketing contracts signed between SABIC and its subsidiary companies. The Interviewee 8 on the other hand defined the assets of SABIC *sukuk* as being the right of marketing of the products of SABIC subsidiary companies, and that right had been hired to *sukuk* holders.

From the responses of the members of the board in relation to the nature of the assets of the SABIC *sukuk*, the following inferences can be drawn:

(i) The members of the SBSS are divided over the nature of assets in relation to SABIC *sukuk*, which is part and parcel of the previous differences, which has already been discussed featuring the labelling of SABIC *sukuk*. The previous difference has

focused on the label of *Shari'ah*-based contract featuring SABIC *sukuk*, while the current difference is over the assets of SABIC *sukuk* that will be sold to *sukuk* holders which determines the profits to be given to *sukuk* holders;

(ii) The members of the SBSS are of different opinion in relation to the nature of assets as some believe that the assets of SABIC *sukuk* represent 'the benefit generated by selling the product of SABIC subsidiary companies', and as has previously been mentioned benefits represents a percentage of profits as a function of interest rate as a benchmark. However, other believe that SABIC *sukuk* represent 'the marketing contracts between SABIC and its subsidiary companies', while Interviewee 8 argued that the underlying SABIC *sukuk* asset is 'the right of marketing the products of SABIC subsidiary companies or what is known as privilege right'.

6.3.2.2 The real transfer of the assets

Interviewee 6 has made it certain that a full transfer of *sukuk* assets to *sukuk* holders have taken place in the arrangement of SABIC *sukuk*, so that no other party will have the right of ownership of those assets, as they will become the sole ownership of *sukuk* holders. In other words, he stated that *sukuk* holders were considered to be the only party that will have the authority to dispose of the *sukuk* assets. In addition, the process of *sukuk* transfer will be legally documented.

As for the Interviewee 7, he assumed that it will be incumbent on SABIC that have the privilege of marketing, to transfer the marketing contracts with its subsidiary companies to *sukuk* holders. The Interviewee 8, on the other hand, agreed with the rest that, the *sukuk* assets in the case of SABIC *sukuk*, have been transferred to *sukuk* holders. Yet, further argued that the transfer process should not be affected by the fact that those assets have been referred to in SABIC financial records as debts. In his view, the realities and facts should make all the difference rather than what is being written in the accounting records.

In addition, according to the Interviewee 6, he pointed out that the structure of SABIC *sukuk* had been initially presented to the SBSS. However, the board had made some comments on the structure including the fact that the transfer of *sukuk* assets was not real. Thus, taking that point into account, the SBSS have managed to make the required amendments to make SABIC *sukuk Shari'ah* based contract.

From the responses of the members of the board to the transfer of SABIC *sukuk* assets, the following inferences can be drawn:

(i) The members of SBSS agree that a real transfer of *sukuk* assets from the issuer (SABIC) to *sukuk* holders has taken place;

(ii) One of the members of the SBSS has asserted that the transfer of *sukuk* has been legally documented;

(iii) One of the members has made it clear that it is not necessary that as a condition for the transfer of *sukuk* should not feature on the financial records of the issuer, and the fact that those assets feature on SABIC financial records (the issuer) as debts should affect the transfer of ownership as what counts is facts on the ground rather than what feature in the accounting records;

(iv) According to the other member of the SBSS, the real transfer of assets gives the *sukuk* holders the full freedom to have control over their underlying *sukuk* without being restricted by the issuer.

6.3.2.3 The periodical profits given to *sukuk* holders

It should be mentioned that there is an argument regarding the returns on *sukuk* as to whether the returns are consistent with the *sukuk* assets and according to the performance of the assets of SABIC *sukuk* or that is only determined by the market interest rates rather than the nature of *sukuk* assets according to some interviewees who are not from SBSS.

The Interviewee 6 pointed out that SABIC *sukuk* returns are the function of the marketing process, *i.e.* the higher the marketing the higher the returns. On the other hand, SABIC as a representative (*wakeel*) of *sukuk* holders in the marketing process together with *sukuk* holders have agreed on a fixed return based on a percentage rate to be consistent with SIBOR or LIBOR benchmark for instance, to be given to *sukuk* holders so that any excess money should go to the reserve account in favour of *sukuk* holders. The main reason for fixing the rate based on a certain benchmark is to overcome any accounting difficulties regarding the distribution of profits generated from *sukuk* assets as those assets vary from one month to another. However, having said that a confirmation should be made that any reserve accounts should go to *sukuk*

holders and will be used to compensate for any deficits in the periodic profits to be distributed among *sukuk* holders, and that in case of liquidation any sums that remain in the reserve account will be given to *sukuk* holders.

Interviewee 7 (a second member of *Shari'ah* board) has also made it certain that the profits and periodic returns should be linked to *sukuk* assets rather than the benchmark. However, linking the returns to the index should be for the sake of stability of returns. To explain this matter, he noted that some companies such as insurance companies prefer low risk investments with stable returns such as *sukuk*. By contrast, insurance companies avoid investment in shares where the risks are high and returns are high compared to *sukuk* though those returns are not stable. However, some group of investors prefer to opt for *sukuk* by arguing that they do not mind to go for low returns as long as those returns are stable. They believe that such returns will enable them repay their financial commitments to other companies. Thus, the stability of returns on the issuance is an important requirement for the issuance to succeed. For that reason, the purpose of the reserve account is to achieve stability; thus, the argument that the profits are generated by the company that sells *sukuk* (SABIC) rather than *sukuk* assets is not true.

From responses of the SBSS members, the following conclusion can be drawn:

(i) There is an agreement among the members of the SBSS that the return from *sukuk* is a function of *sukuk* assets and that SABIC as a seller has nothing to do with *sukuk* returns;

(ii) The members of the SABIC SBSS pointed out that an agreement between SABIC and *sukuk* holders exist regarding the determination of profit percentage and linking that percentage with the interest rate benchmark as it becomes difficult to work out monthly profits given the variable nature of profits not to mention the fact that linking profits with the benchmark is useful in terms of stability of returns.

(iii) One of the members has stressed that whatever goes to the reserve account should be owned by *sukuk* holders after *sukuk* expires.

6.3.2.4 The source of the *sukuk* returns

On the issue of the *sukuk* returns, some of the non-SBSS member interviewees argued that the profits given to *sukuk* holders are linked to the financial solvency of the *sukuk* issuer (SABIC) rather than the performance of the assets of *sukuk* itself. For that reason, they believe that there is an indication of the fact that the existence of *sukuk* assets in the current application of *sukuk* in Saudi Arabia is a formality, which should be considered as an important revelation.

According to the Interviewee 6, a member of the SABIC *sukuk* SBSS, only those who deal in traditional bonds will be concerned about the financial solvency of the issuer; however, this should not be a worry for *sukuk* holders. This, however, should distinguish the difference between *sukuk* and traditional bonds, as the latter give profits based on the financial solvency of the issuer, not to mention the fact that bonds do not feature any assets but rather bond price, which is considered to be a debt to be owed by the issuer to the bond holders with no commitment of buying and selling. By contrast, the idea of *sukuk* structures is different as *sukuk* feature assets to be owned by *sukuk* holders so that the returns should be a function of the value of the assets irrespective of the financial solvency of the *sukuk* issuer. Thus, any decrease in the value of the assets will mean a decrease in the returns of *sukuk* as the returns are a function of *sukuk* assets and have nothing to do with the financial solvency of the issuer as the case with *riba*-based bonds.

From responses of the SBSS members on the issue of *sukuk* assets and its link with the return, the following can be concluded:

(i) the members of SBSS have made it certain that the financial solvency of SABIC company as a seller has nothing to do with the determination of returns, and that the return is usually a function of the size of marketing of the products of the companies by SABIC;

(ii) One of the interviewees explained that depending on the financial solvency of the issuer and the benchmark interest rates are the two features of *riba*-based bonds rather than *sukuk*.

6.3.2.5 The value of *sukuk* after circulation in the secondary markets

On the issue of the value of the sukuk after circulation in the secondary markets, some interviewees who were not from SABIC *sukuk* SBSS mentioned that the value of *sukuk* after circulation in the secondary markets are not affected by the value of *sukuk* assets, but rather affected by the periodical batches of *sukuk* as well as the market interest rates. In another words, there is no real link between the value of *sukuk* and the underlying assets of *sukuk*. Thus, there is an indication of the fact that the existence of *sukuk* assets is a formality.

It should be noted that there seems to be wide debate among the non-SBSS member interviewees that have taken place involving many of the critics of *sukuk* who argue that in practice the increase or decrease of the value of assets in the financial market does not affect the value of *sukuk* as the case with traditional bonds. However, those critics believe that it has been observable in the *sukuk* market that the value of *sukuk* assets may increase or decrease, while the value of *sukuk* remains almost the same. In other words, no real relationship exists between *sukuk* value and the value of the underlying assets, pointing out that the former is really affected by the periodic payments of *sukuk* by increasing or decreasing as well as the interest rates.

According to the Interviewee 6, a member of the SABIC *sukuk* SBSS, with regard to *riba*-based bonds, the above mentioned observation should be true, however, not with regard to *sukuk*. In his view that should distinguish between *sukuk* and bonds, as the latter is linked to the index and the value of the bond will be determined accordingly. However, since there are no assets to be owned by bond holders, the bonds become a debt to be owed to the holders by the issuer with no purchases or sales taking place. In case of *sukuk,* the situation is different as there are assets to be owned by *sukuk* holders, and that those assets generate profits as has already been mentioned.

On the other hand, the Interviewee 7 seems to be unsure as to whether following circulation in the secondary markets, the value of *sukuk* will not be affected by the changing value of the underlying assets, but rather affected by the periodic payments of *sukuk* as well as the prevailing interest rates. However, the Interviewee 7 made some correction to admit that there could be some link between *sukuk* value and the periodic payments as well as the index, nonetheless that should not mean they would

be affected by one another. He went on to argue that investors featuring the financial markets are well aware that all financial activities will be affected by the interest rates even though a direct link might not exist. For that reason, a link might be suggested bearing in mind the fact that the return from *sukuk* would be linked to LIBOR, which would definitely be affected. In this regard, according to the Interviewee 8, it should be assumed that the value of *sukuk* should be affected by the underlying assets rather than the periodic payments and the index by increasing or decreasing their value.

From response of the SABIC *sukuk* SBSS members interviewed, it can be pointed out that:

(i) The members of the SBSS explained that they are not aware of the element that makes SABIC *sukuk* a real attraction to investors: is it *sukuk* assets and the profits they generate or the name and reputation of SABIC Company in the market and its financial solvency?

(ii) As far as *sukuk* is concerned the increase or decrease in returns should be proportional to the increase or decrease in the value of assets irrespective of the benchmark as the returns are usually a function of *sukuk* assets rather than the financial solvency of the issuer as the case with *riba*-based bonds;

(iii) Two of the interviewees made it clear that after circulation in the secondary market, *sukuk* value becomes affected by value of *sukuk* assets increasing or decreasing and that the periodic payments of *sukuk* or market interest rates has nothing to do the matter, while the Interviewee 8 pointed out that a relationship could be there but with no effects.

6.3.2.6 The multiplicity of duties and responsibilities of the issuer (SABIC)

On the issue of the multiplicity of duties and responsibilities of the SABIC in the case of SABIC *sukuk*, a number of interviewees who are not among the SBSS members argued that the *sukuk* assets are controlled by the *sukuk* issuer (SABIC), and also the SPV is a company affiliated to the issuer (SABIC) as well as the marketing agent is SABIC, which indicate the formality of *sukuk* structure as the *sukuk* holders have no real assets that could be considered in case of insolvency of the issuer or otherwise its failure to meet to its financial commitments.

The Interviewee 6 pointed out that all *sukuk* should be like that, and to make things clear SABIC should be the basic company with specific duties, while the SPV, being one of the SABIC subsidiary companies, should also have specific duties. For that reason, it could be maintained that the fact that both SABIC or one of its subsidiary companies is multifunctional should not affect the validity of *sukuk* in terms of *Shari'ah* perspective. Consistency with *Shari'ah*, given that in some of the *sukuk* that have been issued recently the issuer, the SPV and the marketing agent are the different entities. On the other hand, Interviewees 7 and 8 also mentioned that even if SABIC has multiple duties it does not mean that the SABIC *sukuk* are formality.

From response of the interviewees it can be concluded that all of the interviewees stressed that as long as SABIC company is considered as the issuer of SABIC *sukuk* and also the SPV of the SABIC *sukuk* assets as well as the marketing agent, this multiple functions of SABIC company does not implies the formality of *sukuk* structure.

6.3.2.7 The nature of the assets of *sukuk* in the case of insolvency or failure of SABIC

In case of insolvency or failure of SABIC to meet its financial commitments towards *sukuk* holders, what are the assets of SABIC *sukuk* (marketing contracts) that could be considered and claimed by the *sukuk* holders?

In responding to this question, Interviewee 6 stressed the point that the contracts must refer to the legal action to be taken in case of bankruptcy or failure of SABIC company to live up to its duties regarding the *sukuk* holders. In his view, there must be certain measure to be taken to deal with the problem, as the assets on which *sukuk* holders rely would be a *manfa'ah* contract rather than tangible assets.

Nonetheless, the Interviewee 7 argued that in case of SABIC company going bankrupt, the *sukuk* holders will look for another company to undertake the marketing of products of SABIC subsidiary companies, in which case *sukuk* holders would resemble shareholders, and should have a general assembly that would make decision in case of crisis as would be indicated in the issuance prospectus.

From response of the interviewed SABIC *sukuk* SBSS members, the following conclusions can be drawn:

(i) Differences in opinion exist among the members of SBSS with regard to the disposition of SABIC assets by *sukuk* holders in case SABIC goes bankrupt, and what *sukuk* holders should do.

(ii) Two of the members of the board mentioned that the issue of bankruptcy is being dealt with in the prospectus of issuance, and that *sukuk* holders have the right of appointing another marketer in case SABIC goes bankrupt.

6.3.2.8 The Contracts Between SABIC and its Subsidiary Companies

A debate emerged among those who are not from the SBSS whether SABIC continuously sign marketing contracts with its subsidiary companies or does it do that only when the need arises to create assets to issue *sukuk* (formality of assets).

In responding to this, Interviewee 6 confirmed that the marketing contracts representing the assets of SABIC *sukuk* would have already existed, and that those contracts would not have been created for the sake of *sukuk* assets as some would think. The Interviewee 7 also agreed with Interviewee 6 that the marketing contracts should have already been there and would not have been created for the sake of the *sukuk* assets, and also there should not be interference between SABIC contracts. In other words, those contracts have been used more than once by SABIC to issue *sukuk* as some believe and that the SBSS has reviewed all the documents. Nonetheless, he further stated that from *Shari'ah* perspective there will be nothing wrong with the contracts between SABIC and its subsidiary companies to create assets for *sukuk* provided that those contracts are real and valid.

From the responses of the members of SBSS to the above question, it can be concluded that the members of the board have agreed that the existing marketing contracts are already existed and the issuer has not created the marketing contracts just for the purpose of issuing *sukuk.*

6.3.3 Guarantee of the Capital and Returns

This section aims to present and discuss the material gathered from the interviewees on assurance of capital and returns in the contractual design of SABIC *sukuk* by focusing on individual issues in each of the following sections

6.3.3.1 The undertaking of the *sukuk* issuer to purchase the *sukuk*

On the issue of undertaking of the *sukuk* issuer to purchase the *sukuk,* Interviewee 1 pointed out that *sukuk* holders do not have to sell to SABIC, but as yet SABIC has made a commitment by promising to buy the marketing contracts from *sukuk* holders which have initially been sold to them by the company. However, it remains up to *sukuk* holders to sell their *sukuk* to SABIC or otherwise retain them, as they have no commitment towards SABIC. In other words, SABIC would be happy to buy the *sukuk* if the holders decide to sell them for the par value and the company has to live up to that promise. In other words, what has been given is a mere promise rather than a guarantee.

Furthermore, the argument that SABIC preserves the right to consider the *sukuk* as a financial commitment under to the bond section in the balance sheet, which should mean the SABIC is committed to pay the par value to *sukuk* holders after five years even though it has sold to them. Thus, what has been raised as criticism is considered as an accounting error, which could be a potential error to be made by the accountants who are not knowledgeable of *Shari'ah* matters so that they consider *sukuk* as a formal substitute for the bonds. However, the Interviewee 7 believes that this constitutes a main problem for *sukuk* issuance in general as such financial assurances by the issuer are unavoidable. He also highlighted the fact that matter has been allowed by a number of *Shari'ah* boards without objection to such kind of assurance, as currently most *sukuk* require such promise.

Thus, in this section the following generalisations can be drawn:

(i) Differences among the SBSS with regard to the question 'whether or not SABIC provides a guarantee to buy *sukuk* assets at the nominal value from *sukuk* holders' remains an issue;

(ii) Among the members of the SBSS, some made a distinction between the guarantee and the binding promise, and what has been given by SABIC is an obligation or binding promise rather than a guarantee to buy the assets at the nominal value but that is not binding to *sukuk* holders;

(iii) One of the members has made the point that *sukuk* cannot be issued without a guarantee and that scholars have been divided over that argument, while some have backed the argument, others have called for redrafting the structure of *sukuk* as to replace the guarantee by a binding promise by the issuer.

6.3.3.2 The AAOIFI standards with regard to the guarantee of the capital

On the issue of AAOIFI standards with regard to the guarantee of the capital, SABIC gives the right to *sukuk* holders to recover their *sukuk* every five years at the face value not at the market value (90% from the capital plus 10% as a return which means 100% will be guaranteed), which is inconsistent with AAOIFI standards.

According to the Interviewee 6 of SBSS, the assets of SABIC *sukuk* is the sole ownership of *sukuk* holders and that an initial arrangement has been made between SABIC and *sukuk* holders that has allowed SABIC to buy the *sukuk* for their par value. That arrangement has been based on a previous promise from SABIC to buy the *sukuk* for the par value, though that should not affect the validity of the contract. However, Interviewee 6 referred to what has been mentioned in the prospectus of issuance regarding SABIC commitment to purchase for the par value, which should be, in his evaluation, inconsistent with AAOIFI standards, so that he will consider reviewing the matter regarding commitment with the members of SBSS. The Interviewee 7, being the second member of the SBSS also agreed with what has been mentioned by the Interviewee 6 that such a commitment will be inconsistent with the AAOIFI standards. However, he mentioned that this has become a necessity. In relation to this, the Interviewee 8 argued that such type of assurance should be allowed and should not be in contradiction with AAOIFI standards as in fact the matter should be considered an agreement in advance rather than an assurance. That could be so as SABIC had managed to hire its right of marketing the products of its subsidiary companies to *sukuk* holders, and in the meantime had made an agreement with *sukuk* holders that it would retrieve that right from *sukuk* holders at the rate of 90% from the capital plus 10% return at the end of the first five years depending on the desire of *sukuk* holders a matter that would be allowed by *Shari'ah*. This, as an issue, was cleared by the Interviewee 8 who maintained that any arguments referring to capital assurances should be inaccurate as the 10% to be paid to *sukuk* holders at

the end of the five years would have nothing to do with the capital but would represent interests and profits to be paid from the reserve account.

From the responses of the members of SBSS to the above question, the following conclusions can be drawn:

(i) One of the SBSS changed his mind during the interview by denying that what was given by SABIC was a commitment, and instead considered that as a guarantee and that he would discuss it with SBSS;

(ii) Two of the board members are of the opinion that SABIC *sukuk* feature a guarantee which might have been dictated by necessity;

(iii) One of the members has made the point that what has happened between SABIC and *sukuk* holders has been an agreement in advance rather than a guarantee and that should be consistent with the AAOIFI standards.

6.3.3.3 The guarantee of the capital and the returns from an independent third party

It has been argued that why the issuer have no right to guarantee the capital and the returns, while an independent third party has the right of capital assurance in favour of *sukuk* holders.

In responding to this issue, Interviewee 6 considered SABIC as an independent party as the *sukuk* have been sold to the *sukuk* holders. Therefore, after that deal had been completed, SABIC would have nothing to do with *sukuk* so that the relationship would be between *sukuk* holders and SABIC subsidiary companies. In such a case, from a *Shari'ah* perspective, SABIC would be allowed to give capital assurance to *sukuk* holders. The Interviewee 7 also explain that there would be nothing wrong with the capital assurance to be given to *sukuk* holders provided that assurance would be given by a third party independent of both the issuer and *sukuk* holders as dictated the Islamic *Fiqh* Academy for that practice to be allowed. However, theoretically speaking, that assurance could be provided voluntarily by an independent party; as yet in practice that would be inapplicable.

From the responses provided by the interviewed members of SBSS to the above question, the following conclusions can be drawn:

(i) SABIC is allowed to give guarantee with regard to the capital and returns as SABIC is considered an independent party after selling the *sukuk* bringing its relationship with *sukuk* assets to an end;

(ii) The grantor must be an independent party from both the issuer and *sukuk* holders;

(iii) Bringing a third party, as a grantor, will be theoretically possible but will be inapplicable in practice.

6.3.3.4 The commitment of SABIC to pay the *sukuk* holders profits

It could be argued that SABIC considers its delay of fulfilling its financial commitments to *sukuk* holders as a sign of fail as it has been mentioned in the prospectus, and accordingly, *sukuk* holders have the right to claim the full recovery of *sukuk* from SABIC at the face value.

In exploring such an issue, Interviewee 6 is of the opinion that such structure should not affect the *sukuk* in terms of *Shari'ah,* as it is *Shari'ah* compliant. As such a structure implies that *sukuk* holders would own the assets which the issuer had promised to purchase when *sukuk* expired or otherwise in case of failure of payment of the periodic returns to *sukuk* holders.

On the other hand, the Interviewee 7 referred to the fact that the failure as stated by the prospectus of issuance should be related to SABIC as an agent representing *sukuk* holders rather than as the first owner of *sukuk* assets (SABIC Company). To be more precise, SABIC has two entities: first; as the company that has sold *sukuk* assets to *sukuk* holders, and second as an agent representing *sukuk* holders in marketing the products of its subsidiary companies. However, SABIC (as a representative of *sukuk* holders) could manage to market the products, and eventually could collect the revenues but for one reason or another could stop short of paying *sukuk* holders which would be considered as a failure case. Thus, in this case, the failure will be related to SABIC as a representative of *sukuk* holders rather than a company. Consequently, the main duty of the representative or agent is to give assurance to buy the *sukuk* from

sukuk holders for the par value in case of his failure to distribute the sums generated from the marketing process.

On the other hand, Interviewee 7 explained further that SABIC issuance has been among the first *sukuk* issuances in Saudi Arabia, and so there must have been some commentary on it, and accordingly some improvements to *sukuk* structure have been made since then. However, it is worth mentioning that had the SABIC *sukuk* presented to other *Shari'ah* boards, they would not have approved particularly the issue relating to the commitment of the issuer to buy the *sukuk*. However, the current *sukuk* structure does not include the commitment of the issuer to buy for the par value, and SABIC *sukuk* have been issued prior to the statement of the AAOIFI.

From the response of the interviewed SABIC *sukuk* SBSS, the following can be developed:

(i) Commitment by SABIC to buy the assets at the nominal value provided they have failed to do the periodic payments should be consistent with *Shari'ah* principles;

(ii) SABIC has given the guarantee to buy the assets at the nominal value by virtue of its capacity as a representative of *sukuk* holders rather than the issuer, so that in terms of *Shari'ah* it will not be allowed for the issuer to provide guarantee for the capital.

6.3.4 The Reserve Account of Profit

The reserve account of profit has emerged another contentious issue; and this section therefore aims to report and discuss the position of the interviewed SABIC *sukuk* SBSS, particularly with regard to the issues related to the reserve account of profit.

6.3.4.1 The control of profit reserve by the *sukuk* administrator (*sukuk* issuer)

In exploring the control of profit reserve by the *sukuk* administrator (*sukuk* issuer), Interviewee 6 explained that establishing a reserve account will have a positive impact as it tends to keep the balance right for investors with regard to their return earnings. He argued that such account will reassure *sukuk* holders that they will receive the right amounts of the periodic profits as that account will compensate for any potential deficits. Eventually, that will make life easy for *sukuk* holders who will most likely be major companies and organisations regarding business transactions with other

companies in relation to financial commitments, so that those companies will not face any difficulties regarding the undertaking of any financial commitments.

The Interviewee 7 has also confirmed that the reserve account could be described as the 'safety valve' for investors, as investors always seek for stable returns. However, some critics of *sukuk* have a wrong perception that *sukuk* returns are always fixed, and that distinction should be made between fixed returns and stable returns. In terms of *Shari'ah,* any fixed return is disallowed (*haram*) as it relates to *riba*. On the other hand, the stable return is different as those returns might decrease or increase depends on the performance of the business and the reserve account will readjust those returns.

In reflecting on the responses provided, according to the response of the members of the SBSS it can be pointed out that the members of SBSS have commended the idea of a virtual reserve account as that account tends to set the balance right for investors regarding the returns they earn.

6.3.4.2 Explaining the rate of periodic profits and reserve profits

Sukuk holders have the right to know all the details related to the periodic profits of *sukuk* as well as the sums to be kept in the reserve account. It could be argued that whether that right really exists and whether SABIC, as the *sukuk* administrator, explains the real *sukuk* profits to *sukuk* holders, or whether *sukuk* holders have no idea about the real profits, and they only know about the profit to be initially determined by the *sukuk* administrator based on LIBOR index. These are the issues explored with the interviewees as the members of the SABIC *Sukuk* SBSS, which are discussed as follows:

The Interviewee 6 has responded by presuming that SABIC has a duty to provide an elaborate explanation of the periodic profits as well as the sums to be kept in the reserve account in favour of *sukuk* holders. However, Interviewee 6 added that it is the duty of the company auditor and accountant to explain the annual profits and the sums to be kept in the reserve account in the annual report featuring the total revenues and whatever sums are available in the reserve account. Nonetheless, that report should not prevent the SBSS from undertaking its role in following up the flow of money into the company and the distribution of the sums that have been collected and checked as to whether or not the transactions are taking place according to *Shari'ah*

principles. In other words, it becomes an essential matter that the reserve account should be monitored by the SBSS to avoid *riba*-related transactions. Thus, the matter should not be left to SABIC company alone without the close follow up and control of SBSS.

From the responses of *Shari'ah* board members to the above question it can be concluded that;

(i) There is an agreement among the members of SBSS that the *sukuk* holders have the right to know all the details related to the periodic profits as well as the sums to be kept in the reserve account;

(ii) One of the members has explained that the accounts in relation to the profit reserve have nothing to do with the board, while another member has maintained that the prospectus of issuance provides every detail with regard to the reserve.

6.3.4.3 Authority of the assets manager (SABIC) in relation to the sums to be kept in the reserve account

As stated by the issuance prospectus of SABIC *sukuk*, the *sukuk* manager (SABIC Company) has the right of investing all sums of money to be kept in the reserve account to his advantage so that the returns will be his own right. However, in case, the *sukuk* manager lives up to his commitments in paying the periodic sums to *sukuk* holders according to schedule, then any remaining sums when *sukuk* expire will go to the *sukuk* manager as a motivation.

In this regard, the Interviewee 6 referred to the fact that the above authorisation has been forbidden by the SBSS. The board has issued a verdict signed by the members referring to sums featuring the reserve account as the ownership of *sukuk* holders alone. That verdict by the board should apply to every case where *sukuk* is involved otherwise one should question the difference between *sukuk* and bonds. In fact, there will be no difference as long as the returns to *sukuk* holders have been predetermined so that they have no right on the remaining sums. Such procedure should not be permitted, and that the *sukuk* manager should not be eligible for more than the percentage originally allocated for him unless *sukuk* holders voluntarily give up their rights regarding the sums featuring the reserve account, in which case the *sukuk*

manager will be allowed to invest the sums in the reserve account to his advantage as well as pocketing the remaining sums as a motivation when *sukuk* expire.

The Interviewee 7, on the other hand, argued that the process of dealing with the reserve account could vary from one issuance prospectus to another. For instance, in some issuance prospectus, *sukuk* holders tend to allow the issuer to use the sums available in the reserve account to his advantage as the case with SABIC *sukuk*, where at the end of the period the remaining sums featuring the reserve account will go to the *sukuk* manager. It should be noted that in some issuance prospectus make it incumbent on the *sukuk* manager to invest the sums available in the reserve account in favour of *sukuk* holders. However, in the first case, there is nothing wrong with the procedure in terms of *Shari'ah* as long as the *sukuk* manager has been authorised by the *sukuk* holders and the manager of the assets will be as a guarantor (*damin)* due to the investment of the assets for his interest. However, at the end, when *sukuk* expire the sums featuring the reserve account will go to the issuer as long as the *sukuk* holders have voluntarily given up their right on the remaining sums in his favour, and nothing wrong with that from *Shari'ah* perspective as well.

As for the Interviewee 8, he argued that from *Shari'ah* perspective, it is allowed for investing the sums in the reserve account in favour of the *sukuk* manager, as the *sukuk* manager has to make some profits and those gains should feature the sums to be kept in the reserve account.

Based on the discussion presented in this section, the following conclusions can be drawn:

(i) There is an agreement between the members of SBSS that the issuer of the manager of assets has the right to collect whatever remains of the reserve account as a bonus when *sukuk* expires provided that *sukuk* holders agree to give up their right on that money;

(ii) The manager of assets has got the right to dispose of the reserve account in his favour with the consent of *sukuk* holders.

6.3.4.4 Method of determining the share of the new *sukuk* holders from the reserve profits

As a matter of fact *sukuk* circulate in secondary markets, and that should raise the question as to how the share of the new *sukuk* holders from the reserve profits could be determined? In other words, after selling *sukuk* from one holder to another should raise the question as to whether the money available in the reserve account will be taken by seller according to his share or will automatically be owned and transferred to the new buyer and how could that be determined?

The Interviewee 6 has referred to the fact that whatever money is related to profits, no matter the size of it, should go to *sukuk* holders, and yet profit calculation is not among the duties of the SBSS. While the Interviewee 7 argued that all matters in relation to profit calculation have to be included in the issuance prospectus and that prospectus has to be accessible to all *sukuk* holders. The Interviewee 8, however, is of the view that the final *sukuk* structure has to be presented to the *Shari'ah* board for close examination leaving other aspects and cases to specialists who have the ability to deal with matters in more detail.

From the responses of SBSS to the above question, it can be concluded that the justification of the method used by SABIC to *sukuk* holders either is not a duty of SBSS or it can be seen in the SABIC *sukuk* issuance.

6.3.5 Questioning *Gharar* Issues in SABIC *Sukuk*

Since *gharar* constitutes one of the main *Shari'ah* compliancy issues in Islamic finance, this section aims to report and discuss the position of the SBSS members of the SABIC *Sukuk* on various aspects of the (non) presence of *gharar* in their *sukuk*.

6.3.5.1 The evaluation of the SABIC *Sukuk* assets

According to the prospectus of issuance of SABIC *sukuk,* the *sukuk* assets have been evaluated at SR 5,000,000,000 and that will raise the question as to how those assets have been evaluated.

The Interviewee 6 being the member of the SBSS explained that SABIC Company has nothing to do with the evaluation, and there is an external party who has to do the evaluation of the assets as indicated by the issuance prospectus. Moreover, it is not

essential that the *Shari'ah* board reviews the evaluation in detail as the board is not concerned with those details. In addition, the *Shari'ah* board should be presented with a general rather than a detailed report. In the meantime, Interviewee 7 referred to the fact that the method of evaluation of *sukuk* assets has to be included in the prospectus of issuance so that nothing is being hidden from *sukuk* holders.

6.3.5.2 Difference between the nominal value and the market value of *Sukuk* assets

An important controversial issue is the difference between the nominal and market value of *sukuk* assets. This sections aims to examine this particular issue with the contribution of the sampled interviewees.

One of the non- SBSS member interviewees highlighted the fact that the market value of the assets of many *sukuk* is not equal to the actual amount to be paid by *sukuk* holders for obtaining those assets. In this regard, Interviewee 6 referred to *sukuk* evaluation as being fair and accurate as it is being undertaken by specialised parties. Nonetheless, he argued that in case of a significant variation between the market and the nominal values, and then *sukuk* holders have to refer to the issuer (SABIC Company) for the final decision. However, in case the issuer concedes a significant difference and an error in evaluation exists, then *sukuk* holders preserve the right of consulting a neutral third party for arbitration. By contrast, Interviewee 7 is of the opinion that it is not essential what has ever been paid by *sukuk* holders for the assets are actually equal to the market value of those assets. In other words, the validity of *sukuk* should not be affected by the market value of *sukuk* assets. However, in case of an unfair evaluation of *sukuk* assets that should be a matter for *Shari'ah* courts. Nonetheless, those matters are not being stated in the issuance prospectus, as they do not originally feature as problematic during the evaluation process.

6.3.5.3 The extent to which *sukuk* holders are aware of the nature of *Sukuk* assets they purchase

Sukuk structures have always been the focus of enquiry by many critics as to whether *sukuk* holders are aware of the actual (market) value of *sukuk* assets, the potential returns from those assets, and the nature of the contracts between SABIC and its subsidiary companies, and the identity of the subsidiary companies that have become

involved in the marketing contracts as well as whether the contracts between SABIC and its subsidiary companies are available to be reviewed by *sukuk* holders.

According to the Interviewee 6, the answers to the above questions should feature in the issuance prospectus, and as long as the prospectus of SABIC *sukuk* has all the details and answers for all those questions above, then there is no *gharar* involved in SABIC *sukuk*. As for the Interviewee 7, he mentioned that all information concerning *sukuk* is supposed to be available for investors either electronically via the company's website or alternatively in the prospectus of issuance. Nonetheless, the problem lies with the investors themselves as they never search those sources for the right information. Yet, as long as that information is available for *sukuk* holders then SABIC *sukuk* can be described as being safe.

From the responses of the interviewed SABIC *Sukuk* SBSS members to the above two questions with regard to *gharar* the following conclusions can be drawn;

(i) The prospectus of issuance has explained the method of evaluation of SABIC *sukuk;*

(ii) As it has been pointed out by one of the members, the members of the SBSS will not be aware of the details of the evaluation;

(iii)The evaluation of SABIC *sukuk* has been consistent with the market value;

(iv)The validity of the contract will not be affected by the inconsistency between the market value and the nominal value;

(v) The matter has to be referred to a neutral third party or *Shari'ah* courts for evaluation should there be a big difference between the market value and the nominal value;

(vi)The details featuring the prospectus of issuance should deny any potential risks pertaining to SABIC *sukuk.*

6.4 DISCUSSION

The discussion so far included a critical examination of the available body of knowledge in relation to various *sukuk* related *Shari'ah* issues and dimensions, which

are explored further by specially and directly focusing on the SABIC *sukuk* through the perceptions, understandings and opinions of those SABIC *sukuk* SBSS members as well as non-SBSS members. This section aims to provide a critical and integrated analysis through an interpretative discussion on the issues presented and discussed in the previous sections.

Recalling that SABIC company issued three issuances of *sukuk* in the years 2006, 2007 and 2008, and that a review of the prospectus of issuance of the three types had approved by SBSS that the three issuances were very similar in terms of structure. Given that the third and the last issuance is the subject of this study, the 'prospectuses of SABIC *sukuk'* with the relevant documents to SABIC *sukuk* such as the 'purchase commitment agreement', the 'transfer of ownership of *sukuk* assets agreement', the 'agreement of management of *sukuk* assets' also have been closely evaluated and examined in this section based on the *sukuk* recommendations issued by AAOIFI (2008), AAOIFI Standards (2010) with regard to *sukuk*, the Islamic *Fiqh* Academy's decisions and also those who have been interviewed whether SBSS or those who have been interested in the subject of *sukuk*. Hence, an integrated interpretative discussion is provided in the following sections by referring to the emergent issues in the preceding sections.

6.4.1 The importance of defining the mode of the SABIC *sukuk* contract

It could be argued that the prospectus of SABIC *sukuk* has not clearly stipulated the name of the contract that SABIC *sukuk* structure based on, which is essential according to AAOIFI (2010) as well as the Islamic *Fiqh* Academy's Decision No 178(4/19). Instead, the Prospectus Issuance of SABIC *Sukuk* (PISS) only stipulates that "Some of the assets of SABIC *sukuk* have been put on sale for investors" (PISS, 2008). In another place of the prospectus of issuance, it has been stipulated that "SABIC will transfer *sukuk* assets to the custodian (SPV) of SABIC" (PISS, 2008). In addition, the prospectus of issuance also states that "The *Shari'ah* board has reviewed the third issuance of marketing investment *sukuk (istithmar sukuk)*" (PISS, 2008).

It should be noted that by reviewing SABIC *sukuk* 1, 2 and 3 it has been discovered that the prospectus of issuance has failed to label, in *Shari'ah* and legal terms, the contract that constitutes the basis for SABIC *sukuk*. However, under the term 'investment *sukuk'* in AAOIFI Standards (Standard No: 17) it has been stipulated

many types of *sukuk* as follow "These *sukuk* include *sukuk* of ownership of leased assets, ownership of usufructs, ownership of services, *Murabahah, Salam, Istisna'a*, *Mudarabah*, *Musharakah*, investment agency and sharecropping, irrigation and agricultural partnerships" (AAOIFI, 2010).

Eventually, as a result of failure to label the contract clearly, the members of SBSS have been divided on that issue as to whether SABIC *sukuk* could be labelled as a contract featuring the sale of usufruct (*sukuk al-manfa'ah)* or whether it features the sale of marketing rights or could be labelled as selling privilege rights or alternatively the contract could be an *ijarah* contract and that no assets have been sold so that the process has involved the renting of the marketing right of the products by SABIC to *sukuk* holders.

In addition, it could be argued that the differences between the members of SBSS regarding the labelling of the contract and failure to label the contract clearly in the prospectus of issuance should make an impact legally as well as in *Shari'ah* terms on the contract *per se* and the parties involved in the contract as well. Thus, according to the *Shari'ah* principles for a contract to become valid in *Shari'ah* terms, the first requirement is labelling the contract or referring to any mode that indicates the name of the contract or otherwise the nature of relationship between the two parties involved in the contract as it has been stated by the Islamic *Fiqh* Academy's Decision No 178(4/19). Consequently, every party knows the intentions of the other party being sale, rent *(ijarah),* partnership (*musharakah*) or any other form of *Shari'ah* contracts (Merah, 2008). For that reason however, the validity of the contract depends on a 'mode' that expresses the will of the contractors in terms of the purpose of establishing that contract, as it has been asserted by the SBSS through the interview analyses presented in the preceding section and summarised in Table 6.1. In this regard, AAOIFI (2010) stipulates that; "Any *sukuk* should be issued on *Shari'ah* based contract".

Table 6.2: The Opinions of the Interviewees on the Nature of SABIC *Sukuk* Structure

	Interviewee 6	**Interviewee 7**	**Interviewee 8**
Name of the contract	*'sukuk al- manfa'ah*	'rights *sukuk'* or 'rights of privilege *sukuk*'	'marketing *sukuk*'

Nature of the transaction	SABIC sold the *manfa'ah* of marketing the products to *sukuk* holders	SABIC sold the 'marketing contracts' or SABIC sold the rights of marketing the products to *sukuk* holders	SABIC leased its right of marketing the products to *sukuk* holders

Having said that, every contract is different with regard to the rights and commitments both in legal and *Shari'ah* terms, which should be observed by all parties involved in the contracts. Thus, from *Shari'ah* and legal perspective, failure of the prospectus of issuance to label the contract or otherwise bring something that refers to that matter could lead to *Shari'ah* and legal risks. Those risks could involve the validity of the contract or could put *sukuk* holders at risk with regard to claiming their rights on the assets associated with *sukuk* that have been bought from SABIC in case of conflict.

From the forgoing discussion it could be stated that in case the SBSS is unaware of the name of the contract as well as the consequences of that and if differences might emerge among the members over that matter, then the differences even more probable among *sukuk* holders. In other words, given the differences among the members of SBSS on the nature of the contract and the failure of the prospectus of issuance to clarify that, it seems that the subject of the contract remains unclear for both the members of the SBSS as well as for *sukuk* holders. This is an essential concern causing *Shari'ah* as well as legal risks, which undermine the entire process and trust to the process. This can have adverse implications on the development of Islamic capital markets in Saudi Arabia and also globally.

6.4.2 Reflecting on the Assets of SABIC *Sukuk*

This section renders a critical discussion based on the literature and the above-presented interview analysis on the aspects and dimensions of assets of SABIC *sukuk*.

6.4.2.1 The nature of the SABIC *sukuk* assets

One of the basic rules of dealing with others in business such as buying and selling is awareness of the item to be sold which is one of the elements that validates the selling process as has been explained by *Shari'ah* scholars; otherwise, it would not be possible to sell something unknown to the buyer indicating ignorance and naivety and

renders the contract legally invalid in *Shari'ah* terms as it has been noted by Ibn Qudamah (2003). However, according to the prospectus of SABIC *sukuk*, it has been stated that *sukuk* assets represent: "the rights for twenty years span featuring specific commitments as indicated by the marketing contracts between SABIC and its subsidiary companies" (PISS, 2008).

From this stipulation, it could be argued that there is some sort of ignorance exists with regard to what it has been sold with SABIC *sukuk*. Since the item to be sold features rights and commitments, it seems that SABIC *sukuk* documents and process did not clarify by the prospectus of issuance as to the nature of those rights and commitments which makes it impossible for one to become involved in a contract that stops short of explaining the exact subject of the deal. On the other hand, with regard to the argument that the assets of SABIC *sukuk* represent the marketing contracts between SABIC and its subsidiary companies, which have not been attached to the prospectus of issuance not to mention the fact that SBSS as well as *sukuk* holders have not reviewed; or otherwise, it could be argued that *sukuk* holders have no right to review those contracts as being provided by the prospectus of issuance, which states that *"Sukuk* holders have no right to request the issuer to reveal information regarding the activities of the other party" (PISS, 2008). In another place of the prospectus, however, it is stated that; "The *sukuk* holder has no right to examine the marketing contracts between SABIC and the subsidiary companies" (PISS, 2008). Accordingly, the rights of *sukuk* holders as well as the assets of SABIC *sukuk* are not specified, since there is no right for *sukuk* holders to look at and review the contracts between SABIC company and its subsidiaries according to the statements mentioned early from the PISS.

Thus, the question is how could *sukuk* holders be able to buy *sukuk* assets that they have not been aware of and has not been described in a way that eliminates their ignorance with the item being sold as well as the nature of the contract so that knowing the real value of those assets and potential revenues to be generated by the assets *etc*. will be unknown to *sukuk* holders. More importantly, as the discussion identified, the SBSS also failed to review the 'marketing contracts' between SABIC and its subsidiary companies, as it has been pointed out in the interview. Having said that the marketing contracts between SABIC and its subsidiary companies and the

associated rights and commitments which are considered as assets of SABIC *sukuk*, and that SABIC is not given permission to put them on sale, lease them or otherwise transfer their ownership to other parties under any circumstances as being provided by the prospectus of issuance, as stated by the prospectus: *"Sukuk* holders have no right to sell *sukuk* assets or dispose of them in any way but according to purchase contract" (PISS, 2008). In another part of the prospectus it has been stated that; "the transfer of ownership of *sukuk* assets from the issuer to *sukuk* holders does not give *sukuk* holders the mandate or the right of marketing or selling of any of products of the other party or the examination of any of those products" (PISS, 2008).

In addition, those contracts represent temporary agreements between SABIC and its subsidiary companies, as they have the legal right whether SABIC or any of the subsidiary companies to opt out of the agreement and sever the contract by providing an initial notice to the other party. In the words of the prospectus, hence, "no assurance can be given that any of the Marketing Agreements will remain in force for the duration of the *Sukuk*" (PISS, 2008). This might represent a great risk to *sukuk* holders through losing the assets, which are the profits generated from the marketing contracts between SABIC and its subsidiary companies.

Moreover, for those who argue that the assets of SABIC *sukuk* represent privilege rights as has been already mentioned, it could be maintained that from a legal point of view, SABIC *sukuk* cannot be labelled as privilege, which is further be discussed at the next chapter in discussing the legal aspects of SABIC *sukuk*.

The other view that considers *sukuk* assets as the usufruct (*manfa'ah*) featuring the marketing of the products of SABIC subsidiary companies can be refuted by the fact that any usufruct should be linked to a source, as it has been indicated by Usmani (2007). Therefore, in case of SABIC *sukuk*, what is the source that generates the profit as the contracts between SABIC and the subsidiary companies being unproductive of the profits *per se'* cannot represent the source.

According to the above discussion, it becomes clear that the assets of SABIC *sukuk* could neither be described as an a tangible assets, as it has been noted by one of the SBSS, or usufructs, nor could be described as a rights that could be sold, but instead it could be described as a future financial revenues (future receivables) generated from

marketing services provided by SABIC to its subsidiary companies as would be explained by the prospectus of issuance. This kind of structure, however, has been discussed by Merah (2011). In this respect, the prospectus of issuance of SABIC *sukuk* has stipulated that SABIC *sukuk* represent the cash revenues to be generated from the marketing services: "SABIC has issued *sukuk* 1 and *sukuk* 7 worth SR 3 billion and SR 8 billion respectively), whereby 77.06 of the total marketing revues gathered by SABIC has been transferred to SPV in favour of *sukuk* holders" (PISS, 2008).

Therefore, the assets of SABIC *sukuk* are either the money itself to be collected in the future from SABIC subsidiary companies or the right of obtaining the money to be gathered in the future from SABIC subsidiary companies which are in both cases the transaction is not *Shari'ah* compliant as it has been argued by Dagi (2011), Merah (2011), Alroshood (2013).

6.4.2.2 The real transfer of the assets

According to the AAOIFI Standards (2010), there must be a real transfer of ownership from the issuer to *sukuk* holders so that those assets disappear legally from the financial records of the issuer to be transferred to the financial records of the holders, as *sukuk* holders have to retain the full legal right to dispose of their assets. It should be mentioned that this matter has been confirmed by one of the members of the SABIC *Sukuk* SBSS who maintains that according to *Shari'ah* rules *sukuk* holders should have the full freedom to dispose of *sukuk* assets with no restrictions by the issuer.

However, as discussed above, all the members of SBSS are in an agreement regarding the full transfer of SABIC *sukuk* from the issuer to *sukuk* holders. In addition, SBSS has previously noticed that when SABIC *sukuk* has been presented to them for the first time they have noticed that a legal transfer of *sukuk* in *Shari'ah* terms from the issuer to *sukuk* holders has been non-existent, and that the SBSS has introduced some amendments to the structure to feature a real transfer of *sukuk* assets. Nonetheless, by reviewing the financial records of SABIC *sukuk*, it has been noticed that the underlying assets of SABIC *sukuk* still appear on those records of the issuer and being referred to them as debts owed by SABIC, which indicates that no real transfer of assets has taken place. This denies the existence of assets in the first place in relation

to SABIC *sukuk*, but rather refers to financial deposits paid by *sukuk* holders into SABIC bank account only to be paid regular profits in return.

However, as discussed above, one of the members of SBSS stated that what is written on the records is insignificant and ineffective, and he pointed out that what is important is the fact on the ground. In addition, this view cannot be entertained and should be considered as erroneous and inaccurate, which has been objected by many *Shari'ah* scholars and legal experts that the confirmation of rights with regard to financial transactions is an important matter, so as to avoid any *Shari'ah* and legal conflict between the parties involved in the contract, and documents provide an important evidence for the court in case of disputes as it has been asserted by (Usmani, 2007; Ayub, 2009; Al-sayed, 2013; Islamic *Fiqh* Academy's decision No 188 (3/20); Usmani, 2013).

As for those who believe that *sukuk* holders have voluntarily given up their rights to dispose of their *sukuk* by giving the full right to SABIC, that argument can simply be refuted by the fact that *sukuk* holders have actually given up their rights and that decision has been irreversible, which has been a precondition set by SABIC to complete the contract and not an option given to *sukuk* holders as dictated by the prospectus of issuance in the following statement: "Under no circumstance should *sukuk* holders retain the right to dispose of *sukuk* assets including selling and marketing" (PISS, 2008). In another place, however, the prospectus states that "Amendment to the decisions to be made by the meeting of *sukuk* holders or addition of proposals can only be made with the consent of the issuer (SABIC)" (PISS, 2008).

Consequently, from the forgoing, it could be understood that *sukuk* holders have been deprived of the legal right of absolute disposal of the *sukuk* they own in return for the guarantees given by SABIC with regard to the capital and profits. This makes needless for *sukuk* holders to claim their right of full disposal of the assets they own, or otherwise they are indifferent about a real transfer of assets as long as those assets are guaranteed by SABIC, as this view has been supported according to one of the interviewee.

Thus, from the above it becomes obvious that what is going on in relation to SABIC *sukuk* assets indicate that a real transfer of *sukuk* assets has not taken place from

Shari'ah and legal perspective, which is considered as a risk to be avoided. In reality, hence, what has happened could be as a sum of money that has been deposited into SABIC account by *sukuk* holders in return for profits on that sum which is considered as a bond based transaction.

6.4.2.3 The source of returns in SABIC *sukuk*

It has already been pointed out that the main differences between *riba*-based bonds and Islamic *sukuk* is that the return on bonds is linked to the capital, in the sense that the profits represent a percentage of the capital given to the bond holders as the relationship between the issuer and bondholders is like the relationship between a creditor and a borrower. By contrast, the returns on *sukuk* should be a function of *sukuk* assets, and that whatever profits are generated from *sukuk* should go to *sukuk* holders bearing in mind the fact that those profits are neither fixed nor are they predetermined as the case with bonds, but rather increase or decrease depending on the market performance and other factors, and yet those profits can be estimated (Almenea, 2010; Usmani, 2013). However, a critical review of SABIC *sukuk* reveals that the prospectus of issuance states that *sukuk* holders are to be given a certain percentage of the capital as profits irrespective of the expected returns of *sukuk* assets and that specific percentage should be linked with the expected profits, which means SABIC only takes into account the nominal value of *sukuk* and determines a specific percentage of profits. While SABIC links the returns to the LIBOR to bring the stability to returns, as it has been pointed out by one of the members of SBSS, however, SABIC has failed to give in the prospectus an estimate of the expected revenue of *sukuk* assets which is a basic right of *sukuk* holders, which indicates that SABIC company rather than the *sukuk* assets is the actual source of the returns.

6.4.2.4 Determining the percentage of returns

An examination of the SABIC *sukuk* prospectus demonstrates that the prospectus of issuance stipulates that *"Sukuk* holders are eligible for a certain percentage of profits based on their capital" (PISS, 2008). However, as discussed above, according to one of the SBSS member interviewed, the determining of such a percentage is due to the difficulties associated with working out periodic profits by accountants, as well as for

the sake of stabilising the return in favour of *sukuk* holders. Having stated this, it should be noted that the argument that the periodic determination of profits is difficult for SABIC company seems to be inaccurate particularly in relation to SABIC company with all the capabilities and the expertise in financial matters including accounting and other aspects which requires giving particular attention to the profit so that such excuse becomes unacceptable.

The issues, however, relates to as to whether the profits have been determined as a function of the capital, and whether that determination is based on a comprehensive investigation and well study of the prospective profits from the assets of SABIC *sukuk* or otherwise as a function of interest rates and the financial solvency of the issuer as the case with *riba*-based bonds as it has been discussed above. It could be argued that *sukuk* issuers perceive conventional bonds as potential competitors and that the returns on bonds are normally linked with the interest rates; and it seems that *sukuk* issuers seems to consider that they have to take the current market interest rates into account as it has been mentioned by one of the interviewee. For instance, 5% interest rates for *riba*-based bonds implies that *sukuk* must be issued at a similar price or less in order to be economically feasible as to compete with the bonds for the issuer to avoid loss. However, according to Merah (2011), a brief financial study featuring SABIC *sukuk* shown that SABIC has gained more profits than *sukuk* holders by three fold in only five years given that *sukuk* holders are the actual owners of the assets, and by definition *sukuk* holders should have the larger share of the profits rather than SABIC. This should indicate that determining the percentage of profits given to *sukuk* holders has not been subject to a close investigation and examination of the real profits of SABIC *sukuk* which could be generated, as it has been suggested by Usmani (2007) and Almenea (2010). However, it seems to be based on the financial solvency of SABIC Company as well as the indictor of interest rates as it has been noticed by Merah (2011).

However, as discussed above, one of the interviewed SBSS member stated that linking the returns to be earned by SABIC *sukuk* holders with a market benchmark, such as LIBOR, is based on an agreement between SABIC and *sukuk* holders for the adjustment of a stable return seems is considered as an inaccurate justification. Nonetheless, it could be stated that linking the return with the market benchmarks is

due to the fact that no real assets exist for SABIC *sukuk*, and that *sukuk* holders in reality does not own real assets; otherwise the determination of returns should have been linked to the real returns of the assets, so that the revenues to be generated from *sukuk* should go to *sukuk* holders, as they are the true owners of the assets in which case linking with a specific benchmark will be unjustifiable, and that the returns, no matter more or less, should go to *sukuk* holders as this suggestion has been supported by Almenea (2010).

Therefore, it can be concluded that the determining the rate of returns in SABIC *sukuk* is considered not *Shari'ah* complaint due to the fact that there is no real justification for that determination in the issuance of SABIC *sukuk* as well as it has been discovered that the percentage adjusted by *sukuk* manager was in favour of SABIC rather *sukuk* holders. In addition, the differences between what *sukuk* holders received as profits and what SABIC gained a mater which is questionable and that could make no difference between *sukuk* and bonds as both of them seem to be depending on the market interest rates.

6.4.2.5 The link between *sukuk* holders and the financial solvency of the issuer

As the discussion in the previous sections indicate, the denial of SBSS members that no relationship exists between *sukuk* issuer (SABIC) and *sukuk* holders, and the *sukuk* assets have been sold by SABIC to *sukuk* holders severing any financial relationship with *sukuk* holders reducing the role of SABIC as a marketing agent representing *sukuk* holders, contradicts the prospectus of issuance which stipulates that "SABIC is committed to paying the periodic payments to *sukuk* holders as well as to buying the *sukuk* at the nominal value" (PISS, 2008).

Therefore, as far as *sukuk* holders are concerned, to become a grantor, it is very important for SABIC to be financially solvent as well as have a good financial classification and reputation in the market as it has been pointed out by one of the interviewee. In this regard, it should be noted that *sukuk* holders will take into account the issue of financial solvency of SABIC, and will greatly focus on that matter in which case their capital and their periodic returns will be guaranteed from a company with a strong financial solvency such as SABIC Company. In other words, it could be argued that the *sukuk* holders might completely ignore the underlying assets of the *sukuk* as long as the capital is guaranteed. Furthermore, it can be said that one of the

reasons that make *sukuk* holders focus on the financial solvency of the issuer is that if SABIC financial solvency has not been strong then the risk will be high. Consequently, the profits will be high to set the balance right between the high risk and the high profit. A case in point is the *sukuk* featuring *Dar Al-Arkan,* where a high percentage of profit were given to compensate for the poor solvency of the *Dar Al-Arkan* company comparing to SABIC, which puts the capital at risk so that *sukuk* holders have to bear the burden of any potential losses of the capital. Therefore, in case of SABIC, the *sukuk* holders have accepted the small percentage of profits based on the guarantee given to them by SABIC in relation to the capital and the returns, and *sukuk* holders most likely go for low risk investment with a fixed return in order to avoid the loss of capital. Thus, for *sukuk* holders to guarantee their capital would imply that the grantor, which SABIC Company should be in a high financial solvency level as has been previously mentioned.

6.4.3 The Guarantee of Capital

After closely examining the responses of the members of SBSS regarding the guarantee given by SABIC to buy the *sukuk* at the nominal value; the following critical reflections can be made.

First; as can be seen in Table 6.2, there have been significant differences among the members of SBSS with regard to whether SABIC has really given the guarantee to buy at nominal value from *sukuk* holders. One of the members of SBSS responded positively by confirming that there is a guarantee given by SABIC to buy *sukuk* assets at the nominal value as he stated that such guarantee is against the principle of *Shari'ah* and he promised to discuss that matter being non-*Shari'ah* compliant with other members of SBSS. On the other hand, another member stressed that a guarantee has been given out of necessity as it will be impossible to issue *sukuk* without given a guarantee to buy at the nominal value. This clearly explains the reason for inconsistency with AAOIFI standards with regard to the guarantee of capital as SABIC *sukuk* have been issued in advance of the emergence of AAOIFI standards. Another member believe that no guarantee has been given by SABIC to buy at the nominal value, however, the fact of the matter is that SABIC has given a binding promise that it will buy at the nominal value from *sukuk* holders, and that promise is not binding to *sukuk* holders as they are free to keep the *sukuk* for themselves or sell

them to a third party other than SABIC when the expiry date is due. It should be noticed that some of the members have added by stating that SABIC has not given a guarantee but an agreement has been made in advance between SABIC and *sukuk* holders to buy at the nominal value.

Table 6.3: The Opinions of the Interviewees on the Guarantee of Capital

	Interviewee 6	**Interviewee 7**	**Interviewee 8**
Guarantee of the Capital	There is a guarantee in SABIC *sukuk*	There is a guarantee in SABIC *sukuk*	There is no guarantee in SABIC *sukuk*
Justification	The guarantee given was mistake as he will discuss this issue with the SBSS	There is a necessity and SABIC *sukuk* have been issued before the issuance of AAOIFI standards	There is a binding promise *(Wa'ad)* rather than a guarantee

Second; it seems that the members of SBSS are not steadfast their opinion, as some of the members are of the view that no guarantee has been given by SABIC featuring the prospectus of issuance, then they have recanted in another question by maintaining that SABIC has really given guarantee of the capital which is inconsistent with *Shari'ah* principle. On the other hand, another member believes that SABIC has not given guarantee, and that SABIC has made a commitment and that a distinction should be made between a commitment (promise) and a guarantee, then they have recanted that view in another question by saying that SABIC has given a guarantee but the guarantee given by SABIC for the capital has been out of necessity.

Hence, after examining the prospectus of issuance, it could be argued that SABIC has given a guarantee to purchase *sukuk* assets at the nominal value as stipulated by the prospectus of issuance in many places that SABIC has made a commitment to buy *sukuk* from *sukuk* holders at their request after five years, and that SABIC will make a payment of 90% of the nominal value to *sukuk* holders and the remaining 10% of the nominal value will be paid from the reserve account, which means the holder will be paid back 100% of what he has paid for his *sukuk*. In those places, the prospectus of issuance provides that: "Five-year duration of *sukuk* has been determined at the point where the investor regains 100 % of the value of his investment at the maximum" (PISS, 2008). This confirm the view that a guarantee of the capital has been given by SABIC. However, the justification given by the members of SBSS feature the following responses:

(i) Reflecting on the position that what has been made by SABIC is a commitment (promise) or agreement rather than a guarantee:

In responding to this, it could be argued that the 'promise' given by SABIC to buy the assets for the capital or otherwise the 'agreement' between SABIC and *sukuk* holders to buy for the capital is quite similar to the term 'guarantee', as the final outcome will be the same in the sense that SABIC has become committed to buy at the nominal value regardless of the term being used either 'commitment', 'agreement' or 'guarantee', the legal consequence will be the same and the difference will be only in the term. However, the meaning and the final result will be the same as it has been discussed above.

In addition to support what it has been mentioned is that the statement made by one of the members of SBSS after the prospectus of issuance has been presented to him featuring the wording and expressions that indicate guarantee, by maintaining that a real guarantee has been given as featured in the prospectus of issuance which amounts to an inconsistency with *Shari'ah* principles, which should be presented to the SBSS again for correction of error. In addition, there are many conditions that have to be applied with regard to the promises given by the *sukuk* manager to be *Shari'ah* compliant as it has been indicated by AAOIFI (2008), AAOIFI (2010) and Almarshood (2013) as well as the Islamic *Fiqh* Academy's Decision No 178(4/19) and Decision No 188 (3/20).

With regard to what has been mentioned by two of the members of the SBSS that only the issuer should make a commitment to buy *sukuk* for the capital, while *sukuk* holders have to be given the option either to sell for the capital or keep their *sukuk* for twenty years before they expire. In response to that view, it could be argued that it will not be in the favour of *sukuk* holders to keep their *sukuk* after five years have passed as the nominal value will start to decrease. Thus, selling *sukuk* at the end of the fifth year will be in their favour as they will be able to claim back their capital from the issuer. That is exactly the case with SABIC, 1, 2 and 3 *sukuk*, as all *sukuk* holders have sold their *sukuk* to SABIC at the end of the fifth year for the capital. In addition, it has been stated by the prospectus of issuance that the duration of *sukuk* is five years which is clear in the following statement: "The duration of *sukuk* has been determined

by five-year duration and at that point the investors will be paid back 100 % of the value of his investment at the maximum limit" (PISS, 2008).

This indicates both the issuer and the holders have already been aware that the capital has been guaranteed through selling at the end of the fifth year which is the year that the issuer has promised to buy the assets at 90% of the capital plus 10% additional profits from the reserve account which amounts to the nominal value of *sukuk.*

Moreover, in response to the argument that *sukuk* holders should make no commitment to sell after five years, it could maintained that, by not forcing *sukuk* holders to make a commitment to sell has been to stop objection in terms of *Shari'ah* based on the argument that it will question their full ownership of the *sukuk* as long as they are committed to sell after five years. However, by assuming that there is no commitment coming from the *sukuk* manager to buy at the nominal value, then it could be argued that the ownership of *sukuk* holders to the assets is unreal as has been explained before. For this reason, *sukuk* holders are given the option to sell at the end of the fifth year or keep their assets, and that option will definitely not take place as the *sukuk* holders will sell otherwise they will lose the chance to get their capital back. Therefore, it can be concluded that there was a hidden guarantee has been given by the issuer to *sukuk* holders to buy at the nominal value.

(ii) The argument that the guarantee given by SABIC is out of necessity:

In response to the position that SABIC had to give guarantee out of necessity, it could be argued that *Shari'ah* rules are being flexible based on the rule that 'necessities render the prohibited permissible' (Mohamad *el al.,* 2013). Therefore, in case of SABIC *sukuk,* what is the necessity that motivates the judgment to allow the guarantee of capital is not clear given the other *Shari'ah* rule that states; 'Necessities is to be assessed and treated proportionally' (Mohamad *et al.,* 2013).

However, one of the members of SBSS interviewed for this study provided an excuse that the Islamic financing industry is still at the infant stage and that there is need for comprising some issues of *fiqh* for the industry to continue and compete with the *riba*-based traditional system. That excuse, however, seems to be unacceptable in the view of one of non-SBSS member interviewees. He argued that Islamic financing industry has been established for more than thirty years as to become a competitor to the

traditional system. Therefore, *Shari'ah* scholars and other groups involved in the industry are capable of creating new products based on different theories and paradigm compared to the current conventional system that is based on giving guarantee for the capital and profits.

(iii) The argument that SABIC is considered as a third party which allow it to give guarantee for the capital:

As has been indicated by the prospectus of issuance, SABIC has many functions. First; it is the issuer of *sukuk*, secondly; as *wakeel* for *sukuk* holders, and thirdly; it is considered as the manager for the assets. This multiple roles would be confirmed by two of the board members of SBSS by pointing out that the guarantee that has featured in the prospectus of issuance has been given by SABIC by virtue of its capacity as an agent rather than an issuer.

However, after examining and reviewing the prospectus of issuance, it has been realised that the guarantee given by SABIC in the prospectus of issuance has been given by SABIC as an issuer and not as an agent. In this respect, the prospectus of issuance provides that SABIC has made a commitment to buy for the capital, and yet the prospectus stops short of explaining in more detail as to whether SABIC has made that commitment as an issuer or as an agent. Moreover, with reference to the financial records of SABIC company, it becomes obvious that SABIC has made a commitment to pay back the value of *sukuk* based on the capital, as *sukuk* are being referred in the financial records as debts owed by SABIC which makes SABIC a grantor as an issuer and not as an agent.

Furthermore, by assuming that SABIC represents a third party, what benefit does the company generates from being a guarantor? As a matter of fact, guarantors are always available in return for a price, and that should not be allowed, as some of the members of *Shari'ah* board argued and as AAOIFI standards stated.

Therefore, as it has been mentioned that the guarantee from the third party should be accepted for many conditions as those conditions have not appeared with regard to SABIC *sukuk* as it has been indicated in the table 6.3:

Table 6.4: Positions on SABIC being as a Third-Party on the Guarantee of Capital

Conditions	SABIC *sukuk* structure
The third party should be independent from the issuer and not owned by the issuer	The third party is one of the companies owned by SABIC
The financial record of the third party should be fully isolated.	SABIC *sukuk* assets documented and written in the balance sheet of SABIC company
The guarantee should be for free	SABIC gave a guarantee for free but with a condition that SABIC will use all the money in the reserve account for its investment.

(iv) The argument that the issuance of SABIC sukuk has preceded the approval of AAOIFI standards

As discussed, one of the board members of SBSS has expressed his unease with the anti-*Shari'ah* malpractices with regard to SABIC *sukuk*, which he considered could be attributed to the fact that the issuance of SABIC *sukuk* has preceded the approval of AAOIFI standards. Nonetheless, by referring to the dates, it has been discovered that AAOIFI *sukuk* standards were issued on 1st January 2003 indicating that *sukuk* standards have already been there before SABIC *sukuk* structure was approved by the concerned SBSS. However, it could be the case that the interviewee's reference could be related to the recommendations for *sukuk* which were issued by AAOIFI in 2008 in response to concern raised from many *Shari'ah* scholars on the standards.

Furthermore, one of the members of SBSS during the interview pointed out that they are not committed to AAOIFI standards which renders the claim that no standards have been available for the *Shari'ah* board members to refer seems to be inaccurate.

6.4.4 The Guarantee of Returns

In exploring the guarantee of returns with SABIC *sukuk* based on the debate presented above, It should be noted that in no circumstance should *sukuk* issuer, the agent of *sukuk* holders or the director of assets give a guarantee for profit or a definite return,

no matter that profit being a specific sum or a percentage of the capital or based on a certain benchmark such as such as LIBOR or otherwise based on the financial solvency of the issuer as it has been pointed out by AAOIFI (2010) as well as the Islamic *Fiqh* Academy. Nonetheless, according to the SABIC *sukuk*'s prospectus of issuance, it has become obvious that a clear guarantee has been given by SABIC for the periodic returns from many aspects as follows:

(i) According to the prospectus of issuance, SABIC is committed to buying *sukuk* at the nominal value in case the company fails to distribute the periodic profits among *sukuk* holders, and that should mean the periodic profits have been granted no matter there have been profits generated by *sukuk* assets or not. The evidence for this is that, SABIC managed to buy the assets at the nominal price as a guarantee in case it fails to pay the specific profits to *sukuk* holders. In addition, it has been stated in the prospectus of issuance that among the failures that requires SABIC to buy *sukuk* from *sukuk* holders at the nominal value as stated in the following statement from the prospectus: "In case the sum to be distributed among sukuk holders by SABIC at the approved dates has been less than the sum that has been defined by the prospectus of issuance, as according to the 'purchase agreement' the issuer should be committed to buy the *sukuk* at the nominal value" (PISS, 2008). This should mean that SABIC has been committed to *sukuk* holders to pay them a specific percentage of the profits based on the capital no matter the project has been profitable or not, and in case of failure to do that SABIC has given them a guarantee to buy *sukuk* at the nominal value. As it has been mentioned that should be a guarantee for the returns. Eventually, any deal involving returns will be *riba*-based which is not allowed in *Shari'ah* terms, and that eliminates the difference between *sukuk* and *riba*-based bonds, as the bondholder would buy his bonds with guaranteed definite returns to be paid by the issuer as it has been noted by Alroshood (2013). In this respect, the same happens with SABIC *sukuk* as the *sukuk* holders bought his *sukuk* to be paid definite and guaranteed returns by the issuer, and in case of failure of the issuer, the *sukuk* holder preserves the right to claim back his capital by forcing the issuer to buy the *sukuk* at the nominal value as prescribed by the 'purchase agreement' between the two parties.

(ii) As discussed previously, SABIC gives promises and makes commitments to distribute the periodic payments among *sukuk* holders in case of failure, and then it

commits to buy at the nominal value. However, that should mean that SABIC has made a commitment to pay the returns no matter it has made a profit from *sukuk* assets or not. In addition, it has already been explained that the assets of SABIC *sukuk* are not based on usufructs or rights that can be assessed as many *sukuk* structures issued. Consequently, the revenues that has been generated by SABIC *sukuk* has not come from *sukuk* assets as those assets are in fact non-existent, rather the revenues have come from SABIC company due the commitment it has made, and that the returns have been determined based on the benchmark and the financial solvency of SABIC.

However, given the fact that the returns are to be originally generated by the assets, the question that needs to be raised at this point as to why SABIC is accused of failure in case the periodic payments to be distributed among *sukuk* holders is less than the sum to be defined in prospectus of issuance. As result of that, SABIC will be committed to buy from *sukuk* holders at the nominal value at the request of the holders. It should be noted that in the first place SABIC should have nothing to do with *sukuk* assets whether or not they generate profit, as the assets have been sold to be owned by *sukuk* holders; and secondly, why should *sukuk* holders refer to SABIC company when there is less sum of money available for periodic distribution as that would be like doing business which is subject to gain and loss, and in the end SABIC becomes a guarantor for the periodic returns.

6.4.5 Critical Reflections on the Findings Relating to Reserve Account

6.4.5.1 The idea of the reserve account

As mentioned previously in sections 2.7.7, 2.7.8, 6.2.7 and 6.2.8, the deduction of part of the profits to be kept in the reserve account aims at the following:

(i) to cope with any potential loss or otherwise decrease in profits during periods when profits become less or vanish;

(ii) to achieve the required balance in future periodic distributions so that differences between periodic distributions from time to time are kept to the minimum possible.

It should be mentioned that the above two reasons should justify the significance of the reserve account, which, as a view, has won the support of the members of SBSS

through their responses to the questions related to the reserve account. However, as indicated by AAOIFI (2010) and Islamic *Fiqh* Academy's Decision No 188 (3/20), in *Shari'ah* terms, the deduction of part of the profit to go to a reserve account is permissible, as the owners of those sums are *sukuk* holders who have donated the money to be kept in a reserve account, given that in *Shari'ah* terms they preserve the right to do so. Furthermore, the condition set by the prospectus of issuance or otherwise by the *Shari'ah* contract for this account to be established should not offend the requirement of the contract, as the permissibility has been stressed by most of the contemporary scholars, including Almenea (2010), Abu-Goudah (2010), Alshobaili (2011) and others, based on the decision made by the Islamic *Fiqh* Academy as well as AAOIFI. It has been argued that such action should be allowable as long as it has been stated by the prospectus of issuance that a specific percentage has to be deducted from the profits or otherwise that deduction of profit has to go to a reserve account as an insurance of the capital against potential risks (Alshamari, 2012). Nonetheless, the decisions of the Islamic *Fiqh* Academy No 178(4/19) and No 188(3/20), and the decision of *Albarakah* Group 8th Symposium for Islamic Economy (2002) stopped short of defining the fate of the money in the reserve account as the purpose comes to end with the expiry of *sukuk* for instance; or otherwise it has not been used for the purpose it has been allocated for; and who will be the owner of those sums of money when *sukuk* expires or has been resold to the issuer (Alanazi, 2012).

6.4.5.2 Deducting more reserve than needed

In relation to reserve account, the AAOIFI standards (2010) states that "The reserves should be established following the decision of the bank management (with the consent of the holders of the investment accounts) to establish a reserve account" (PISS, 2008).

The standard, hence, stipulates that the consent of *sukuk* holders is indispensable, as the bank deduce those reserves from their share of the profits. However, the question is who decides the percentage of deductions of reserves from the profits. In this regard, the AAOIFI (2008) provides the following; "The reserve of the profit rates is estimated in accordance with the amount the management deems essential, taking into accounts all the necessary precautions".

Thus, according to the AAOIFI standards of reserves, the estimation of the percentage of deductions for the reserves is a matter for the management department to decide on. However, what if the management deduced more money from the profits of investors than what was needed as a reserve. As a matter of fact, the accounting systems would allow this and the responsible manager would encourage that as well by giving credit to the management department for being cautious with regard to its investment, as mentioned above. This argument would be acceptable on the ground that the reserve sums would go back to *sukuk* holders. However, the condition set by the manager or issuer that whatever remains in the reserve account should be given to him/her as a bonus, in which case *sukuk* holders will be deprived from a considerable percentage of their profits due to the excessive caution. Moreover, this results in a conflict of interest between the issuer and the *sukuk* holders, as any increases in reserve account will be in favour of the issuer or the manager of assets as an interest-free loan, in which case he/she will be accused of increasing the reserve sums to make the maximum benefit of the reserve sums to his favour.

By examining SABIC *sukuk,* it has been realised that the percentage imposed by the manager of assets has been very high so that the sums to be saved from the reserve exceed that to be distributed among *sukuk* holders by many folds over. In evidencing this Merah (2011) concludes that SABIC has managed to save a total sum of SR 3,937,000,000 in the reserve account, which is equivalent to three folds of the money distributed to *sukuk* holders as profits after five years of *sukuk* duration have passed. This indicates that *sukuk* holders have been deprived of their true profits many folds over than what they have received. In addition, it indicates that the percentage that have been defined by the manager of assets or otherwise the issuer featuring the potential risks has not been real based on the market condition, which is rather, based on LIBOR as has been already explained (Hassan, 2011).

As a conclusion, it follows that giving the management department or the issuer a free hand to define the percentages of reserves is a matter that needs to have the consent of *sukuk* holders in advance not to mention the fact that a real study of the market with regard to the risks involved is also needed, and that all those procedures must feature in the prospectus of issuance as it has been pointed out above.

6.4.5.3 Investing the reserve sums disfavouring *sukuk* holders

As regards to the condition set by the *sukuk* manager (SABIC company) to invest the reserve sums disfavouring *sukuk* holders, this should be consistent with the condition of a loan, a matter that has been confirmed by a group of scholars of Islamic banking as it has been pointed out by Alshobaili (2010). They concluded that such condition should not be allowed due to a number of reasons that have already been discussed by Alomrani (2012). It is already concluded that whatever has been available in the reserve account has to go to *sukuk* holders, so that the profits to be generated by investing that sum should go to the owner of the money, *i.e. sukuk* holders as has been indicated by AAOIFI standards (2010) regarding investment bonds that "The reserves are to be deducted from the profit". Therefore, if the profits go to *sukuk* holders; then whatever to be deducted from those profits must also go to *sukuk* holders when *sukuk* expire (Alanazi, 2011).

As discussed above, from the answers of the members of SBSS, it has become obvious that there is an agreement among them that the issuer or the manager of assets has got the right to dispose of the money available in the reserve account to his/her advantage. It seems that the consent of *sukuk* holders has been obtained by some of the SBSS members as well as some scholar as a condition for that. However, with respect to the sums in excess of the periodic distributions, the prospectus of issuance has stipulated that; "The manager of *sukuk* assets has got the right of using and investing the reserve sums in his favour so that the returns to be generated by using and investing those sums will be the property of the manager alone" (PISS, 2008). This implies that *sukuk* holders have got no option other than accepting that condition that has been documented in the prospectus of issuance featuring the use of the sums in excess of the periodic distributions in favour of the manager of assets and that condition has become a compulsory condition.

However, in fact the prospectus of issuance has failed to provide for a separate agreement involving the promise to buy or the agreement of the management of assets explaining that *sukuk* holders have given their consent to the issuer or otherwise the manager of assets to use the reserve sums and invest them in his favour. This should indicate the fact that the manager of *sukuk* has initially imposed that condition in the prospectus of issuance as a compulsory condition, in which case *sukuk* holders have

no option but give their consent to that condition. Nonetheless, the fact that *sukuk* holders have given their consent to that condition should mean that the capital and the periodic returns have been granted to them, as it is inconceivable that *sukuk* holders will give up their rights with regard to the reserves and the profits to be generated from investing those reserves and accept to receive a small percentage of the profits without being given something in return. In this case, thus, in return, the *sukuk* holders have been given the guarantee of the capital and profits to given by the issuer as has been explained above.

The condition set by SABIC *sukuk* issuer or the manager of assets to use the reserve account in his favour as has been stipulated by the prospectus of issuance should mean that he takes whatever is available in the reserve account as an interest-free loan so that sum will be granted by *sukuk* issuer a matter to be disallowed in terms of *Shari'ah* principles (Alshobaili, 2010). In another word, *sukuk* holders have chosen the issuer (SABIC) as their agent to manage the assets at a price, and in the meantime SABIC has got the right to take whatever is available in the reserve account as a free loan. As has already been explained such practice is disallowed according to the Prophet Muhammad's tradition, who prohibited the act of 'combing between selling and borrowing in one contract' (Alanazi, 2011; Alshobaili, 2011).

Thus, in *Shari'ah* terms the option, according to Dagi (2011), will be either the reserve should be put in a current account in one of the Islamic banks favouring *sukuk* holders rather than the issuer, or to be invested by the issuer or the manager of the assets in favour of *sukuk* holders. In the case of opting for investment, such an investment should feature a *mudarabah* contract in which the two parties agree on a specific percentage of the profits, which should be stipulated by the prospectus of issuance as that should be permissible in *Shari'ah* terms as *sukuk* holders will request the manager of assets or the issuer in addition to his/her duties as a manger of *sukuk* to undertake another task featuring the investment of the reserve sums instead of leaving them inactive. It can be argued that this should be the better option than leaving *sukuk* issuer to take up all the profit in case he/she takes hold of the reserve as an interest-free loan for himself (Alanazi, 2011; Alshobaili, 2011).

6.4.6 The incentive given to the manager of assets

It has already been explained above, there is a disagreement between *Shari'ah* scholars regarding the practicality of the condition set with regard to the incentive given to the manager of assets or the agent, which will be allowed according to AAOIFI standards (Alshamari, 2013). While a number of Islamic banking scholars believe that such practice should be disallowed due to the fact that the issuer or the manager of assets has already been paid for the job, and due to the conflict of interest involved based on evidence from *Shari'ah* as has already been explained (Alanazi, 2011; Alshobaili, 2011). In addition, it has been pointed out that due to the fact that the money featuring the reserve account is being deducted from the profits to be generated by investing the money paid by *sukuk* holders and subsequently, whatever money is available in the reserve account should be possessed by *sukuk* holders alone and should be invested in their favour and that when *sukuk* expires whatever is in the reserve account must go to *sukuk* holders as that money is generated by *sukuk* owned by them as stated by the decisions of *Albaraka* Group Symposium (2002) that "Nothing wrong with deducting part of the profits and postponing its distribution to a later date". This implies that the sums available in the reserve account have been linked to *sukuk* duration so that the sums automatically go to *sukuk* holders when *sukuk* expires.

It could be argued that reforming the practice with *sukuk* as to be Islamic *sukuk* in terms of honesty and justice requires getting rid of the condition that anything in excess of a specific percentage of the net profit must go to the manager. In this regard, the net profit is the right of *sukuk* holders and the manager has no right in it, apart from a reasonable amount such as part of the net profits as a bonus for his good performance of his duties. This point is significant regarding the proof of good performance of the manager, as this justifies as to why he deserves the bonus. Moreover, the bonus should be given with the good intention of *sukuk* holders, and any conditions set with regard to the bonus tend to mimic the traditional banking system by fixing the return, and relating that practice to the Islamic investment products should not be allowed (Alshobaili ,2010;Almenea, 2010; Alomrani, 2012).

It should be noted that a critical review of the of SABIC *sukuk* issuance prospectus revealed a condition set by SABIC (the issuer and manager of assets) to take the

reserve deposit as an incentive, when *sukuk* expires, as the prospectus states that; "When *sukuk* has been cleared the remaining sums of the reserve deposit should go to the manager of *sukuk* assets (SABIC) as a bonus for his good management no matter the clearance has been before or after *sukuk* expires" (PISS, 2008).

However, some of the conditions and restrictions that have been introduced by some of the scholars in Islamic banking to lessen the resemblance of *sukuk* to *riba*-based bonds have not been mentioned in the prospectus of issuance. For instance, Almenea (2010) recommended the condition that the issuer of *sukuk* or manager of assets has to be given a reasonable percentage of the sums left over in the reserve account; Alanazi (2011) suggested that there has to be a *mudarabah* contract between the two parties for sharing the profits; or Merah (2011) stated that there has to be a clear word from *sukuk* holders to donate the assets voluntarily rather than by dictation. Despite all these various positions, the prospectus of the SABIC *sukuk* has not stipulated such conditions, as mentioned earlier.

According to Elgari (2011), nothing wrong with the idea of a reserve account and keeping the returns in excess of the periodic distribution to bring about stability. This, however, should not be made a condition for *sukuk* holders to give it up at the expense of their right even if the amount accumulating in the account equals their original capital that they will give it up to the issuer. However, it could be possible that *sukuk* holders might give up whatever is available in the reserve account when they possess the excess money and preserve the right to dispose of it willingly without being dictated by any one.

6.4.6.1 Explaining the periodic profits to *sukuk* holders

With regards to explaining the period profits to *sukuk* holders, knowing the amount of periodic profits of *sukuk* is among the rights of *sukuk* holders. Thus, the manager of assets has a duty to explain matters pertaining to the earned periodic returns during the various periods featuring statements and financial reports to be presented to *sukuk* holders.

However, as discussed above, two members of the SABIC *sukuk* SBSS have maintained that SABIC is supposed to give an explanation in relation to the rate of periodic returns. In this regard, a review of the prospectus of issuance has revealed

that the return from *sukuk*, which is the percentage of the total sales for every marketing contract, is non-standardised, as prospectus of issuance provides the following (PISS, 2008);

> SABIC is eligible for marketing fees in accordance with the marketing agreement, depending on the quantity of products that have been sold, and that the marketing fees in general is worked out as a percentage from the selling price, given that the rate of marketing percentage differ from one agreement to another.

From the forgoing, it becomes obvious that the rate or the percentage of the profit is unknown, which implies that *sukuk* holders are unaware of what is going on with regard to the profits as long as there is no explanation of the percentage of the profit as it can be considered against the *Shari'ah* rule, as it has been discussed above. In addition, this matter has not been discussed in any of the relevant documents and contracts, as all the agreements and contracts between SABIC and its subsidiary companies responsible for the assets of SABIC *sukuk* indicates that *sukuk* holders have no right of access, as has been discussed.

6.4.6.2 Explaining the excess sums to be deposited in the reserve account

In relation to depositing the excess sum in the reserve account, knowing what has been deducted from the periodic returns of *sukuk* in the reserve account is also one of the rights of *sukuk* holders, as the manager of assets has a duty to explain those reserves during various periods in the form of statements and financial reports to be presented to *sukuk* holders.

However, two of the board members of SABIC *sukuk* SBSS interviewed for this study have made the point that whatever is being deposited in the reserve account of the excess sums will be known to *sukuk* holders. However, according to the prospectus of issuance it becomes obvious that *sukuk* holders have nothing to do with the reserve sums, as those sums will in the end go to the manager of assets as incentive. In other words, *sukuk* holders will not be much concerned about what is available in the reserve account as long as the capital and the periodic returns are guaranteed.

However, in case *sukuk* holders sell their *sukuk* before it expire, then the fate of the excess sums that have been deposited for them in the reserve account to cope up with any potential decrease of the periodic returns becomes questionable. It should be

mentioned that the prospectus of issuance and the attached documents do not make any provision that the sums to be deposited in the reserve account have been given up in advance by the owners in case they have sold their *sukuk*. Consequently, those sums should go to the manager of *sukuk* assets at the time when *sukuk* expire as it has been suggested by Alanazi (2011).

From the forgoing, it implies that the manager of *sukuk* assets has a duty to list the names of investors among *sukuk* holders from whom the profit deductions have been taken for the reserve so that those deductions can be paid back to them when things come to an end in terms of purpose and need, in case *sukuk* expire or has been sold by the holders as those investors are the owners of the profits or otherwise taking the consent of *sukuk* holders to give up the profits being kept for them in the reserve account in favour of the others who have bought the *sukuk* from them in what is known in *fiqh* as '*ibra'a* meaning investors give up their rights of ownership of the reserve account in favour of the reserve account as a donation (Alanazi,2011).

However, there has been controversy among *Shari'ah* scholars with regard to the permissibility of *'ibra'a,* where it has been stressed that in *Shari'ah* terms it is dutiful that the reserve money goes back to the owners whenever it becomes possible to list the names or otherwise donate the money on their behalf to charity organisations rather than leaving the money for the manager of assets as being dictated by *Maliki* School.

6.4.7 Reflecting on the Findings Relating to *Gharar* in SABIC *Sukuk*

According to the prospectus of SABIC *sukuk*, the assets of SABIC *sukuk* were established at SR 5,000,000,000, and *sukuk* have been purchased by the investors based on this evaluation. Nonetheless, based on the findings from the interviews conducted, it can be said that many of the critics of *sukuk* structures have raised questions with regard to the current situation in relation to the method of evaluation of the assets of many *sukuk* structures as SABIC *sukuk* is one of them. However, among the questions as to who has evaluated SABIC *sukuk* is rather urgent, as whether it is SABIC Company, who has done the evaluation or another independent specialised party as it has been indicated by some of the SBSS members interviewed in this study.

In addition, whether *sukuk* holders have been aware of the method of evaluation of the assets of SABIC *sukuk* given that in the end they will become the real owners of those assets, which imply that they must be aware of its real market value in order to avoid gross losses in the value when *sukuk* circulate in the secondary market. Moreover, among the questions as to whether *sukuk* holders are fully aware of the potential returns of those assets as well as the feasibility study featuring the determination of the periodic returns that will be distributed among *sukuk* holders is also rather important. In addition, what is the nature of the contracts (in relation to *sukuk* assets) that have been signed between SABIC and its subsidiary companies, and what are those subsidiary companies that have signed the marketing contracts with SABIC, and whether *sukuk* holders should be aware of those contracts to be signed between SABIC and the subsidiary companies are among other essential issues. It should be stated that all the above questions were presented to persons specialised in *sukuk* business as well as to the members of SBSS.

From the interviews with the members of SBSS it is understood that they sustain their position that the answers to the above queries feature in the prospectus of issuance and that no *gharar* is associated with SABIC *sukuk.*

However, after examining the prospectus of SABIC issuance, the prospectus of issuance fails to answer the above questions and the consequences. As a consequence, *sukuk* holders seem to be alienated with regard to the assets they possess as well as being unaware in terms of the nature of those assets and their market value not to mention the potential returns from *sukuk* assets.

Moreover, according to the prospectus of issuance, *sukuk* holders should not be allowed to look at the *sukuk* assets that have been sold to them featuring the agreements between SABIC and its subsidiary companies, and also *sukuk* holders have no right to make a request for a copy of those agreements or contracts or any information from the issuer regarding the activities of the parties involved in the marketing of the products of SABIC subsidiary companies.

Furthermore, the prospectus of issuance has been ambiguous in relation to the returns and marketing fees as it states the following (PISS, 2008);

> "SABIC becomes eligible for marketing fees following every marketing agreement of the amount of products it manages to sell, and that generally speaking the marketing fees are worked out as a percentage of the selling price so that the rate varies from one agreement to another".

Thus, the rate or percentage is unknown and it is not defined in all documents featuring *sukuk* and the associated contracts, and that the percentage of profits varies from one agreement to another, a matter that the prospectus of issuance has fell short of explaining.

From the forgoing, it could be argued that SABIC has evaluated *sukuk* assets that have been sold to *sukuk* holders due to its need for specific money that SABIC needs for funding. However, as SABIC needs a specific amount of money for funding accordingly, it seems that SABIC has evaluated the assets that it intends to sell to *sukuk* holders to generate that amount, a fact that has been confirmed by some of the interviewees.

On the other hand, as it has been mentioned previously, *sukuk* holders could have not been concerned to know about the nature of assets they are going to possess, their market value or even the real returns of the assets of the *sukuk* they have bought.

In this regard, it could be argued that no matter whether or not *sukuk* holders have bought the assets of the *sukuk* for the price which is equivalent to the market value; their capital will be returned to them, so that knowing the real price of the *sukuk* they have is not an important matter to them, not to mention the fact that the amounts featuring the periodic distributions are granted and fixed and that is what investors in the financial markets are interested in as it has been pointed out by Elgari (2011).

Thus, it seems that SABIC *sukuk* holders will not be interested to find answers to the above questions. However, not having answers to these questions could lead to *ghara*r, which can have important consequences, as the contract will be invalidated as has already been explained.

6.5 CONCLUSION

The analysis and discussion in this chapter is summarised in Table 6.4, which displays the main findings.

Table 6.5: Summarising the Main Findings

No	Evaluation and examination points	Findings Relating to SABIC *Sukuk*
1	The type of the structure of SABIC *sukuk*	It seems that the prospectus failed to identify as to which type of contract the SABIC *sukuk* was based on;
2	The validity of the SABIC *sukuk*	SABIC *sukuk* seems to be *enah* or *wafaa* structure;
3	The real nature of the ownership	The ownership of the assets did not meet all the *Shari'ah* rules, as there is no control over the assets and there is no real transfer of the assets;
4	The validity of the underlying *sukuk* assets	SABIC *sukuk* do not represent the real assets, usufruct or services or otherwise rights that can be financially assessed and evaluated in the market rather it represents future generated money or the right of collecting the future money;
5	The guarantee of the returns	*Sukuk* manager (SABIC) has guaranteed the returns for the *sukuk* holders;
6	The source of the returns	Returns come through marketing the products of SABIC *sukuk* subsidiaries, as there are contracts that SABIC has a duty to market those products. However, those contracts represent temporary agreements between SABIC and its subsidiary companies, as they have the legal right whether SABIC or any of the subsidiary companies to opt out of the agreement and sever the contract providing an initial notice that has been given to the other party;
7	The distribution of profits based on the benchmark	The periodic distribution of profits was based on the LIBOR rather than the real function of the underlying SABIC *sukuk* assets;
8	The guarantee of the capital by promising to repurchase the assets at the nominal value	SABIC company (*sukuk* manager) has made a promise to repurchase SABIC *sukuk* assets from *sukuk* holders for their face value;
9	The guarantee from the third party	SABIC company is not considered as a third party, because it should be separate in terms of identity and financial independence from the two parties of the contract and the guarantee should also be free;
10	The reserves profits	All the profits in the reserve account went to the *sukuk* manager (SABIC company), which was supposed to go to the *sukuk* holders as they are the owner of the reserves;
11	The deducting of reserves	The *sukuk* manager has deducted more money from the returns than what was needed for facing any expected risks, as there is no real study has been conducted for the estimation of profits;
12	The condition set by *sukuk* issuer to benefit from the reserve account	*Sukuk* manager (SABIC Company) received benefit from what is in the reserve account while it should be for the favour of the *sukuk* holders
13	The condition of a loan when the profit becomes less than a specific percentage	In SABIC *sukuk* prospectus, there is no indication that there is any condition of loan in the case of the profit becoming less than a specific percentage
14	The real sharing of profits and losses between *sukuk* holders and *sukuk* issuers	There is no PLS between *sukuk* manager and *sukuk* holders, as the *sukuk* manager (SABIC Company) will bear all the risks against less profit with using all the money in the reserve account as well as taking all the remaining money in the reserve account at the maturity of the *sukuk*.
15	The value of the underlying s*ukuk* assets and how 'SABIC *sukuk* rights' have been assessed and evaluated	The issuance of the SABIC prospectus did not indicate how the 'rights' have been evaluated. This implies that *gharar* is involved. However, it seems that *sukuk* holders do not care as long as their capital and returns are guaranteed

Chapter 7

LEGAL RISKS IN *SUKUK* STRUCTURES

7.1 INTRODUCTION

Islamic financial transactions, especially Islamic financing models such as *sukuk* are surrounded by financial and legal risks. In this regard, a great deal of academic and professional efforts is needed through academic researchers or legal professionals identifying the legal risks associated with *sukuk* structures.

It has been mentioned previously that the systems and regulations that govern the activities of IFIs have been entirely designed to serve conventional financial institutions (Iqbal and Lewis, 2009). Thus, it is quite natural for the IFIs to encounter legal difficulties while trying to cope with regulations and legal frames that do not take the specificities and the nature of Islamic financing into account. In addition to the salient nature of Islamic financing related legal risks, the legal risk potential would vary from one financial institution to another depending on the country in which it operates and the prevailing financial and legal regulations that governs the banking activities in that particular country (Abdullah *et al.*, 2011).

The legal risks are associated with failure to execute financial contracts or otherwise those related to the statute and legislations that govern obligations featuring contracts and business deals (Ahmed and Khan, 2007; Jobst, 2007). These risks could be internal risk relevant to the management of the financial institution and its employees, which could reduce the assets of the institution or increase its obligations in a sudden manner, either for reasons of inaccuracy or non-compliance or for lack of sufficient legal backing or otherwise for engaging in new types of transactions that are yet to become legally provided for or external in nature such as regulations that might affect certain kind of business transactions (Hanafy, 2000).

In exploring legal risk related issues in relation to *sukuk*, this chapter will be divided into three sections; section one explores and discusses the legal risks that *sukuk* structures might exposed through a foundational literature review. In addition, the

risks related to the *sukuk* holders, sales of assets, default, contracts and documentations, legal infrastructure of *sukuk* in various jurisdictions, the conflict between Western law and *Shari'ah* law, legal risks involving bankruptcy, SPV, standardisation of *sukuk* and the lack of application of IF between countries will be highlighted and identified. In providing empirical substance to the provided frame and debate, the perspectives of the interview survey based participants on structure and prospectus of SABIC *sukuk* in relation to legal issues is analysed and presented. The third part of this chapter attempts in meaning making in relation to the legal risks related to SABIC *sukuk* through the analysis of the interviews and the available body of knowledge as presented in the beginning of the chapter. In this critical discussion, the prospectus of SABIC *sukuk* is also considered through deconstruction method.

7.2 LEGAL RISKS IN *SUKUK* STRUCTURES: LITERATURE REVIEW

Sukuk being the major Islamic capital market instrument has gained popularity in expanding the Islamic financial operations. However, similar to any other financial instruments, Islamic or conventional, *sukuk* have potential areas of risks; therefore previous the empirical chapters focused on Shari'ah compliancy and *Shari'ah* risk in the case of SABIC *sukuk* from Saudi Arabia. This chapter, in its focus on risk exposures related to *sukuk* structures focuses on legal risks and the following sections provides a literature survey on aspects of legal risks in *sukuk* structuring by beginning with legal risks associated with *sukuk* holders.

7.2.1 Legal Risks Associated with *Sukuk* Holders

Sukuk holders are the first participants in the *sukuk* market who are exposed to the risk of losing their investment. In this regard, it should be noted that *sukuk* certificates are supposed to prove the ownership of an asset which will generate a periodical return depending on the agreement. However, the availability of a tangible asset is central to the idea of *sukuk*, so that *sukuk* holders must have interest in the asset to be financed by the money collected from selling *sukuk* (Adam and Thomas, 2004). In this regard, AAOIFI rules that investors on *sukuk* should have the full ownership of the associated assets provided that those assets are legally bought from the original owner (AAOIFI, 2010). In this case according to *Shari'ah* law the risks and returns associated with dealing in *sukuk* should be linked to the assets. Hence, even in case of insolvency the originator should be committed to deliver assets to *sukuk* holders (Yean, 2009).

On the other hand, according to AAOIFI (2010) "The Manager issuing *Sukuk* must certify the transfer of ownership of such assets in its (*Sukuk*) books, and must not keep them as his own assets'. In other words, the issuer of *sukuk* has a duty to transfer the assets involved in the books to the ownership of the holders of *sukuk* rather than keeping them as his own property. To reach that end, an agreement should be made featuring the originator and *sukuk* holders as evidence of sale transaction. Such agreement should be given every legal consideration to be enforced.

The AAOIFI ruling should suggest that the design of *sukuk* certificates should reflect the true ownership of the asset involved. In addition The Islamic *Fiqh* Academy's Decision No 188 (3/20) stated that *sukuk* contracts should fulfil all the requirements whereby ownership is legitimately and legally proven, resulting in the ability to act and afford insurance. Contracts should be free from fraud and sham and insuring that they will ultimately guarantee safety from the *Shari'ah* point of view.

It could be argued that the lack of relevant laws and regulations regarding the transfer of assets from the issuer to the *sukuk* holders are the main causes of risks, which may lead to the uncertainty and the lack of transparency (McMillen, 2006).

7.2.2 Legal Risks in Relation to the Sale of Assets

The legal risks involved in the sale of underlying *sukuk* assets become a controversial matter, which relates to the type of sale from the issuer to the SPV whether real or not (Alsayyed, 2014). In case the sale is real, the *sukuk* holders preserve the right of ownership of the asset involved. On the other hand, in case the sale is unreal, the *sukuk* holders will have no right of ownership of the asset (Yean, 2009; Khnifer, 2010). It should be mentioned that losing the right over the asset for being the owner of assets is a great risk that *sukuk* holders may face. In other words, *sukuk* holders and creditors will legally be in the same status in the event of any loss or default and therefore will not be *sukuk* feature on conventional bonds (Khnifer, 2010).

It is noteworthy that from a legal point of view, the registration of the property or asset should be in the name of the new owner, and that arrangement should be considered in case of legal disputes (Howladar, 2009). That should mean in case of sale, the ownership of the underlying asset should be transferred from the balance-sheet of the issuer to *sukuk* holders via the SPV. Nonetheless, in cases where the

obligor declares bankruptcy, investors have recourse to the asset and preserve the upper-hand over unsecured creditors (Ahmed, 2015). In this regard, AAOIFI, (2008) highlighted the fact that sale of assets to *sukuk* holders should reflect all legal rights and obligations with regard to ownership.

Accordingly, it could be argued that the discontinuous relationship between SPV and the issuer indicates that a real transfer of assets has taken place by mentioning the fact that some numerous conditions should be available in order that the sale becomes legally real (Usmani, 2007; Usmani, 2013; Alshamari, 2013):

(i) The majority of SPV shares are owned by investors independent of the issuer;

(ii) The management of SPV is made by a person independent of the issuer;

(iii) SPV must subject to all risks as to gain all the characteristics associated with ownership of the assets.

In addition, Giddi (2000) pointed out that there are some standards that can distinguish between the real sale and what is known as the guaranteed loan, so as long as a relationship exists that makes one understand that SPV has the right to refer to the seller of the underlying assets in case of bankruptcy by the issuer that should make one to understand that the sale becomes unreal. Moreover, in case that the *sukuk* manager has the right in the excess gains that has not been agreed upon from *sukuk* returns, the sale will not be real but rather it will be considered as a guaranteed loan given by the issuer to *sukuk* holders(Amer, 2013; Alsayyed, 2014).

In addition, the gains should not be mixed with the money of the issuer or *sukuk* manager so that if the issuer represents the agent of *sukuk* holders in which case the income should be kept in an independent account separate from the issuer account until its returned to SPV account otherwise that should indicate that no real sale has taken place (Alshobaili, 2011; Alanazi, 2011).

It could be argued that the full meaning of real ownership has been currently missing in many *sukuk* structures as that have been referred to by many *Shari'ah* scholars and experts in relation to real ownership, including Usmani (2007), Almenea (2010), Oudah (2010) and Hassan (2012), Therefore, from the forgoing, it can be understood

that the ownership of the assets should become a risk from both law and *Shari'ah* aspects.

7.2.3 Legal Risks Related to the Keeping the Assets on the Issuer Balance Sheet

One of the risks that can be noticed on *sukuk* structures is the failure of transfer of assets from the issuer balance sheet to the records of *sukuk* holders or their representative SPV as it has been discussed above. However, Elgari (2009) states that in case the company has any intention to buy again the assets that it has sold to *sukuk* holders, there is no need to transfer those assets from the issuer records to SPV, as in such case that will have unfavourable effects on the issuer.

In contrast, among others Almuslih (2011), Dagi (2011) and Alshamari (2013) argued that in case if there is a 'purchase commitment contract' from the issuer to buy again the assets that have been sold to *sukuk* holders, in which case the issuer has no right to make the assets remaining within its records given that it will be returned to him according to the 'purchase commitment contract' at the end of the period as the transaction will be inconsistent with selling contract featuring the transfer of ownership.

In this respect, it can be argued that the condition of keeping the assets on the issuer balance sheet should feature a number of legal risks. First, it could be argued that the legal risks as the prevailing laws do not recognise the ownership of individuals unless it is registered officially under their names. This is due to the fact that AAOIFI (2010) makes a condition that ownership of the assets of *sukuk* has to be in the name of *sukuk* holders as well as the transfer of assets should be made possible by law.

In addition, the remaining of *sukuk* in the balance sheet of the issuer will be returned to him in accordance to the 'purchase commitment contract 'that could make the selling process a nominal process and that an intention is being made on the fact that the contract will be just a nominal (fictitious) to reach the loan with profit (Usmani, 2013).

Furthermore, it could also be argued that in case the assets remain with no transfer from the issuer to *sukuk* holders, there will be no major differences between bonds and *sukuk* especially from legal point of view, as the main differences is that *sukuk*

represent assets or usufructs while bonds represent loans and finical commitments which can be seen in *sukuk* without transferring the assets (Dagi, 2011).

Nonetheless, Elgari (2009) argued that what it has been said is not accurate, as the balance sheet to be issued by the company, which include the underlying *sukuk* assets does not reflect and indicate *Shari'ah* rules that prove or not the validity of selling. Additionally, the balance sheet is not considered as a part of the selling contract so that any in-correction of the balance sheet will make the contract invalid. In other words, the perfection of balance sheet is not made as condition of the validity of the selling contract in which case leaving the assets as part of the balance sheet of *sukuk* indicates that the sale is nominal and not real.

Nonetheless, leaving such assets register as part of the balance sheet of the issuer is an benchmark that the selling, which might be nominal, can be rejected by arguing that nothing will be considered unless the case goes to court in case of bankruptcy or insolvency. However, in case the judges look at the balance sheet of issuer and has discovered that the asset still remain in the issuer balance sheet, in which case the court will become confused as to what they will depend on, as to whether the assets which are part of the balance sheet is still owned by the issuer and has not been transferred or that the documents and what is being indicated by the contract as referring to a sale and that the assets are owned by *sukuk* holders (Elgari, 2011).

On the other hand, it could be argued that no many precedent cases are available in Saudi Arabian courts that can provide a basis for judges so that it could be possible that the courts will depend on what is available in the documents and contracts to provide a guide to prove the transfer of ownership rather than pay attention to the balance sheet that has been suspected of unreal sale (Elgari, 2011).

AAOIFI (2008), however, made it clear that;

> *Sukuk*, to be tradable, must be owned by *Sukuk* holders, with all rights and obligations of ownership, in real assets, whether tangible usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of *Shari'ah*, in accordance with Articles (2)1 and (5/1/2)2 of the AAOIFI *Shari'ah* Standard (17) on Investment *Sukuk*. The Manager issuing *Sukuk* must certify the transfer of ownership of such assets in its (*Sukuk*) books, and must not keep them as his own assets.

According to Hassan (2012), on the other hand, the *sukuk* issuer has a duty to separate those assets from its balance sheet so that it does not remain as part of the assets but out of it, as they have already sold those assets by receiving the payment as he should transfer its ownership. In addition, it should be mentioned that if the assets being available among the assets of issuer it could mean that the sale is not real and that the price he has received from *sukuk* holders represents a loan and that *sukuk* returns are considered as the 'profit of loan' even though it named as *ujrah* (wages) in the case of *ijarah* contract. Moreover, some of the Islamic banks have insisted keeping the rent assets that has been sold to *sukuk* holders as part of its lists of assets (on balance sheet) but instead it has to be 'off balance sheet' (Hassan, 2012).

Hence, the following question can be raised: what is the reason of leaving the assets remaining as part of the issuer balance sheet, while in fact the *sukuk* have really been sold to *sukuk* holders. In this regard, Elgari (2011) pointed out that due to the fact that the issuer will retrieve its assets that has been sold or otherwise has rented them to *sukuk* holders so that claiming out those assets from the balance sheet and then their retrieval will incur taxes to the issuer, which will of course increase the cost of issuing *sukuk* and as a result *sukuk* holders will be affected. Therefore, by leaving the assets within the balance sheet will make one avoid the tax in a way consistent with the law. Moreover, he argued that separating these assets from the issuer balance sheet has negative effects on the company shares on the financial market, and also the process of selling the assets could face some disagreements from shareholders in relation to company. However, in case of government assets, their move out of the balance sheet might become complicated and might need a new law so that *sukuk* issuers could insist on keeping assets as part of the issuer balance sheet. On the other hand, Elgari (2011) also argued that ownership could be proved even without any transfer of assets from the register of the issuer to the record of *sukuk* holders as they are many ways to be used by accountants such as the 'comments' made by the accountant advisor of the balance sheet making the points that the ownership of assets has been changed or otherwise has been mortgaged.

It could also be pointed out that many legal criticisms have referred to the structures of current *sukuk* given to the possible legal conflicts between *sukuk* issuer and *sukuk* holders due to the lack of evidence that provide proof of ownership of *sukuk* holders

of the assets that have bought and also the possibility of their legal capability of proving their right of ownership so that many legal specialists in *sukuk* would see that it is essential to transfer the assets from the balance sheet of the issuer to the register of *sukuk* holders which is consistent with what has been provided by AAOIFI (2008),AAOIFI (2010) and the Islamic *Fiqh* Council in its decision no 188(3/20) as it has already been explained above.

By contrast, as it has been mentioned in Chapter 6 that some believe that it would be enough to transfer just the 'beneficiary ownership' while the title of the assets still remains with the seller as there is no harm for the assets to be remained in the balance sheet of the issuer (the seller). An example could be when the issuer keeps the ownership of the hired assets in his balance sheet and transfers the right of collecting the rent to the *sukuk* holders (Afshar, 2013; Hidayat, 2013).

Nonetheless, many of *sukuk* specialists believe that laws differ from one country to another with regard to the law of transferring the 'beneficiary ownership'. Therefore, one should avoid any dispute which may be caused by the misunderstanding as a result of the differences of the laws and regulations in each country. For example, transferring the 'beneficiary ownership' is considered valid and real sale in one Jurisdiction while it could be against the law in another judicial authority as the case in Saudi Arabia. Consequently, *sukuk* holders will be exposed to one of the legal risks as becoming incapable of proving their legal rights because of the invalidity of the law of transferring the 'beneficiary ownership'(Duaabah, 2009).

7.2.4 The Impossibility of Transmission Assets from the Issuer to the *Sukuk* Holder

It should also be noticed that among the critical issues relating to *sukuk* structures regarding the real ownership is that, the possibility of transferring the ownership of the assets from the issuer to *sukuk* holders, in case such assets represents reigns assets that are not expected to be sold as its ownership belong to main companies such the management buildings of the companies or that those assets belong to governments such as airports and other public domain or that the law of the state will not allow selling to foreigners.

In this respect, Elgari (2011) asserted that despite those who think that the governments and big companies are not expected to sell or otherwise rent their sovereign assets, the current realities have proved that many governments has either sold or rent their sovereign assets. For instance, what has been managed by the UK government by selling Belfast airport to a private company; Austria having sold 47 percent of Vienna airport to the private sector; Switzerland by selling 50 percent of Zurich airport to the private sector, and also Australia following suit by renting 17 of the most important airport for 50 years to the private sector. Therefore, the statement that it is impossible for governments to sell or rent some of its properties is not an accurate statement. Hence, in case the assets have really been transferred to the buyer (*sukuk* holders) will prove that the sell is real rather than nominal.

However, it can be argued that a number of criticisms in relation to *sukuk* structures have been raised, such as the case for the ownership on the sovereign assets. Due to so many conditions on the ownership on the sovereign assets, one may conclude that there is a doubt as well as uncertainty as the sale is not real rather than only the impossibility of selling the sovereign assets (Merah, 2011). Moreover, the associated conditions as well as suspicions will support one another so that in the end they become real that there is no true sale as a result of impossibility of selling an important asset. In another words, re-renting the governments and companies to the assets they have already sold by keeping them in their records and balance sheet, and also the conditions made by those companies and governments as to become agents for *sukuk* holders indicates the impossibility of transmission assets from the issuer to the *sukuk* holder. In addition, it could be also said that *sukuk* holders have less experience and knowledge to deal with investment areas such as airports and public roads or the other public domain. In such conditions, they become forced to accept any conditions set by the *sukuk* issuer including restricting their authority as well as fully controlled upon their assets and that will indicate that the ownership is not in full as has been pointed out by AAOIFI (2008) along with the Islamic *Fiqh* Academy's Decision no 188(3/20).

However, regarding the difficulty and impossibility to register the ownership under the name of *sukuk* holder, if possible amending the state law to allow the sale or otherwise allowing the renting of properties which are owned by the state. However,

by contrast, the register and transfer of the ownership to foreign investors will not be allowed under that law. In which case if the bank and other funding institutions (*sukuk* holders) are foreigners, therefore, in this case, the issuer has to issue a 'bond against' the deed of trust and regency, and need to make a decision that it will keep the ownership (as title) for the *sukuk* holders by the real owners of the assets and that it has no right to transact on those assets without their consent (Elgari, 2009; Almenea, 2010).

7.2.5 Assets Backed vs. Assets Based *Sukuk*

Among the critical legal issues in relation to the ownership of the *sukuk* structures, it is a contentious issue that *sukuk* should be asset backed rather than assets based (Tariq, 2004). In this regard, it could be argued that the concept of true sale from *Shari'ah* and legal perspective is the key difference between asset-backed *sukuk* and asset-based *sukuk* (Khnifer, 2010). In addition, there exist two types of *sukuk*: the first one is known as assets backed *sukuk* in which case the ownership of assets is transferred to *sukuk* holders in real terms, which means that they got the right to access to *sukuk* assets and sell them in case of bankruptcy of the issuer. Nonetheless, the main problem emerges in relation to assets based *sukuk*, as in such cases no real transfer takes place for the assets from the seller to *sukuk* holders (Al-Amine, 2008; Abdul Aziz *et al.,* 2009).

A quick survey of the *sukuk* databases would show that asset based *sukuk* represent the majority of the current issuances, which imply that *sukuk* holders in case of bankruptcy will not be able to claim their assets as there is no ownership on them, as they are not transferred to the SPV in *Shari'ah* and legal terms as it has been discussed before (Godlewski *et al.,* 2010).

According to Usmani (2007), McMillen (2007), Al-Amine (2008) and Khnifer (2010), the differences between asset backed *sukuk* and assets based *sukuk* can be surmised as follows;

(i) In case of asset backed *sukuk*, the *sukuk* holders are exposed to risks in relation to devaluation of the *sukuk* assets in question; for example, risks associated with assets, while in case of asset based *sukuk*, the risks are associated with the issuer and its capability to live up with its commitments;

(ii) In asset backed *sukuk*, the assets will be sold to *sukuk* holders by the issuer as a real sale from legal perspective, which becomes nominal in case of asset based *sukuk*;

(iii) In case of assets backed *sukuk*, the legal risks of bankruptcy of the issuer can be separated from *sukuk* holders, as the assets are kept in an independent separate entity (SPV) while in case of asset based *sukuk*, the risks cannot be separated as the assets are still kept in the balance sheet of the issuer;

(iv) In case of bankruptcy or insolvency, the holder of asset based *sukuk* have no legal right on the assets, however, they have a legal right to go back to the issuer to claim their capital as the relationship is debtor and creditor relationship. As for asset backed *sukuk*, the holders do not have any right to refer to the issuer as there will be no relationship between the issuer and *sukuk* holders as there is a real sale exists after which the relationship has severed.

(v) Consequently, in cases where asset-backed *sukuk* are involved, *sukuk* holders will be able to recover their money through liquidating the asset in the event of default. Again that will not be the case with asset-based *sukuk* as investors' rights on the asset are restricted (Khnifer, 2010).

Therefore, from the forgoing, it could be argued that the structure of assets backed *sukuk* is consistent in and fulfil *Shari'ah* terms. Thus, from legal and *Shari'ah* perspective, assets backed *sukuk* represent '*sukuk* ownership' associated with assets. On the contrary, the structuring of assets based *sukuk* represents a funding process that in reality is not different from the *ribawi* bonds that are not allowed in *Shari'ah* terms; and hence, it causes an objection in *Shari'ah* terms (Cox, 2007; Agha, 2009).

However, according to the recommendations made by AAOIFI (2008), it is stated that in the event of insolvency of originator, investors should have recourse over the asset. Such arrangement will definitely favour investors in the long run. However, as far as the rules of asset-backed *sukuk* are concerned, they are compatible with *Shari'ah* in terms of asset ownership (Yean, 2009). Therefore, the originator needs to make a sale in such a way as to ensure a legal distinction between that sale and the state of bankruptcy of the seller. It is also noteworthy to stress that asset-based *sukuk* is gaining popularity in the *sukuk* market despite the *Shari'ah* concerns raised (Jabeen and Javed, 2007). According to Ahmed (2010), Dusuki and Mokhtar, 2010), only 11

out of 560 or 2% of *sukuk* issued met the requirements of asset-backed *sukuk* as prescribed by *Shari'ah* principles with regard to asset sale to potential investors. In this regard, there is no difference between asset-based *sukuk* and conventional unsecured bonds in terms of recourse to asset (Hassan and Kholid, 2010). Such preference for asset-based *sukuk* is partially due to the fact that the instrument is rated on the basis of the obligor's credit worthiness (Howladar, 2009) rather than the relationship of the *sukuk* to the underlying assets.

While the debate on the legal nature of the asset backed and asset based *sukuk* is an important one in relation to the underlying assets, the reality of what is happening on the ground has alerted practical and professional perspectives on the issue in particular with the finical crisis in 2008. It could be argued that the *sukuk* holders have become aware after a number of default occurred during and aftermath of 2008 financial crisis and hence the debate is further essentialised through financial, *Shari'ah* as well as legal positioning.

In relation to the debate, the conventional bonds that are not allowed by *Shari'ah* can be mentioned, which are known as the asset backed securities. However, in legal terms, there is a difference between asset backed securities and the asset backed *sukuk* as follows; the assets backed *sukuk* is a financial paper that represents assets, while asset backed securities represent financial papers as loan on the issuer and that loan is guaranteed by the mortgage made by the assets (Merah, 2011). Thus, the right of *sukuk* holder is limited to the assets that represented by the *sukuk* only, while in the asset backed securities the right of *sukuk* holder of such type has to do with the issuer and that the assets are a mere guarantee and a mortgage in case the issuer fails to pay the nominal value and the gains (Godlewski *et al.*, 2010).

7.2.6 Legal Risks of Default

While Islamic banking and finance claims 'resilience' in the face of global financial crisis in 2008, there have been a number of defaults associated with *sukuk* since 2008 (Van Wijnbergen and Zaheer, 2013). In fact, every *sukuk* certificate prescribes the legal remedies to be implemented in the event of dissolution, and that those remedies vary from one type of *sukuk* contract to another depending on the issuer. However, it is not usually true that *sukuk* holders have the right of ownership of the relevant asset, so that they can be able to file a law suit against the issuer in case of default, or delays

in payment, or otherwise will be able to force the issuer to buy back the asset as initially being agreed upon in the *sukuk* contract (Usmani, 2007). It could be argued that the uncertainty of the law in terms of the process and the procedures that *sukuk* holders should go through after any default would lead to the legal risk. In other words, the legal statue of *sukuk* holders over their assets would be unclear (Salah, 2010; Jobst, 2007).

7.2.7 Legal Risks Involving Bankruptcy

It should be mentioned that the importance of the bankruptcy law arises from the fact that it preserves investors' rights to receive payments in case of issuers' insolvency or otherwise absolute bankruptcy (McMillen, 2012; Alsayyed, 2014). Unfortunately, such laws are yet to be issued in some countries particularly in the Middle Eastern countries (Marinescu, 2012). However, as far as the GCC region is concerned, the laws of each jurisdiction in the region does not render a specific definition of the term 'bankruptcy', and instead defines an insolvent trader as being a bankrupt (Hassan and Kholid, 2010; Jan and Marimuthu, 2015).The legal uncertainties featured in Nakheel *sukuk* case in the UAE, as *sukuk* holders' right to take procession of the assets in the event of originators' bankruptcy, has not been preserved. That should raise the alarm that asset-based *sukuk* are treated by courts the same as loans (Nazar, 2015), which was the case with *Nakheel sukuk.*

One of the risks in relation to *sukuk* structures emerges in the case *sukuk* becomes bankrupt is where *sukuk* holders are not in any position proving their rights in the assets they own and that have been transferred in unreal manner from the issuer to SPV (Van Wijnbergen and Zaheer, 2013).According to Amer (2013), it has been a common tradition that the transfer of ownership of assets from the issuer to the SPV in order to separate between *sukuk* assets and the risk associated with the issuer. Thus, in such a case the *sukuk* holders will make sure that their assets are separated and kept separate from the assets of the company (issuer) and that they might not be affected in case of bankruptcy of the issuer.

7.2.8 Legal Risks Associated with SPV

In *sukuk* contracts the SPV plays the role of a trustee through which assets are transferred by the originator to *sukuk* holders as beneficiaries (bdulaziz and Noh,

2013). In this regard, trust law needs to be incorporated into both common law and civil law as to govern the SPV establishment, a move which has already been made by Dubai and Bahrain (Nazar, 2015).

The trust law tends to protect the right of the beneficiaries against any offensive acts. In case of common law, however, the legal rights of trustees are bounded to the legal rights of beneficiaries (Thomas, 2007; Khan *et al.,* 2015). By contrast, in terms of civil law, beneficiaries have no control over the assets to be managed by trustees, which becomes problematic to the *sukuk* contracts to be issued in countries under the jurisdiction of civil law. In such countries, *sukuk* holders' right to have recourse to the assets is restricted by law and will be classified as asset-based *sukuk* (Hansmann and Mattei, 1998; Dewi, 2010; Ismail, 2015).

It should be mentioned that since the Saudi system does not have trust law; the legal statues of the SPV is considered as a private company controlled by the Capital Market Law.

It could be argued that in some of the cases involving *sukuk*; the issuer and the SPV may be based in different countries so that a common law that governs the two parties does not exist. This is exactly the case with *Tamweel sukuk* where the SPV is based on the remote Cayman Islands while the originator is based in Dubai (Radzi, 2011). The problem could be arising from the lack of a common law that governs the two parties is even becomes more complex by the laxity of the Island's authorities on enforcing the law in response to the needs of the parties involved. Thus, no matter the origin of the court order in the remote Cayman Islands, the UK or anywhere else in the world, the problem will exist as to the enforceability of the court orders due to lack of bilateral treaties between the countries involved (Frankell, 1998; Dewi, 2010; Khan *et al.,* 2015).

In this regard, Ayub (2009) raised the point that lack of transparency of documentation as well as unclear relationship between parties in terms of obligations and rights could become issues of potential concern regarding *sukuk.* Therefore, it is highly recommended that *sukuk* prospectus should clearly define legal issues particularly those related to rights and obligations of the parties involved in the contract (AAOIFI, 2008).

7.2.9 Legal Risks Related to the Standardisation of *Sukuk*

Some financial organisations involved in regulating *sukuk* structures such as the AAOIFI and the Islamic Financial Services Board (IFSB), put forward appreciable efforts by putting the standards and measures for the issuance of *sukuk.* Those measures have led to the promotion of *sukuk* product and development of Islamic capital market. Nonetheless, those measures stop short of covering all kinds of *sukuk* structures, a matter which deepens the differences between the various *Shari'ah* organisations concerned with the process of *sukuk* approval, and thus increasing the legal risks involved in terms of *Shari'ah* law (Tariq and Dar, 2007;Khan *et al.,* 2015).

It could be argued that the uncertainties associated with transactions involving *sukuk* necessitates the standardisation and streamlining of *sukuk* contracts in terms of legal documentations and *Shari'ah* principles (Ahmed and Khan, 2007). In this regard, AAOIFI (2010) has already managed to standardise *sukuk* contracts, even though the standard contract is not binding to other key players in the Islamic financial industry. Yet, legally speaking, the enforcement of a standard *Shari'ah* compliant *sukuk* contract becomes critical for *sukuk* market. Furthermore, laws and procedures to deal with legal issues need to be uniform with regard to the issuance of *sukuk* (Khan and Feddad, 2004).With such arrangements conflicts in case of default or bankruptcy can easily be resolved as the uniform and standardised legislation will put things under control by eliminating the uncertainties and doubts associated with *sukuk* market as it has been suggested by the decision of the Islamic *Fiqh* Academy's No 188 (3/20) and Vinnicombe (2012).

7.2.10 The Inconsistency of Islamic Contracts

As far as Islamic banks are concerned one of the risks involved is that Islamic financial contracts are different to conventional contracts in terms of contents and purpose. In this regard, the main setback and failure of Islamic contracts is that the rules are incompatible regarding judicial cases related to customer implementation of contracts. This is not to mention the lack of a unified format between the Islamic contracts themselves, and the different nature of Islamic financial contracts as compared to its conventional counterparts. That should lead to variations of judicial rulings with regard to the implementation of those contracts. The fact that every single bank has its own models of contracts unique to them constitutes a main source of risk

(Siddiqui, 2008).Therefore, the legal format of any kind of organisation could be a major role to play an increasing or decreasing the level of risk involved (Al-Amine, 2008).

7.2.11 Risks Associated with the Legal Infrastructure of *Sukuk* in Various Jurisdictions

As far as Islamic finance is concerned, *sukuk* contracts vary from one country to another in terms of legal development as a main determinant of success. The fact of the matter is that, the rules and regulations of traditional banking still dominate the banking business in some countries (Dar and Presley, 2000). Eventually, that does not provide a suitable environment for the proper development of *sukuk* contracts in those countries. For instance, in Indonesia, Asset Securitisation Law does not help the development of *sukuk* contracts as the law provides that asset securitisation can only be structured through debt in contradiction with *Shari'ah* law (Djojosujito, 2007). According to the British Financial Services and Market Act (FSMA) of 2000, the *sukuk* market can be classified under a Collective Investment Scheme (CIS), in which case *sukuk* issuers would be subject to wide control measures with very restricted authority. However, such measures tend to limit the base of asset investment, which favours conventional debt securities over *sukuk* contracts (Nazar, 2015). Therefore, the lack of the legal infrastructure of *sukuk* in various jurisdictions is considered as one of the legal risk facing *sukuk* structure.

7.2.12 Legal Risks Associated with Contracts and Documentations

It has been noted that Islamic banks have been developing new *Shari'ah*-based modes of financing include *murabahah, musharakah*, *mudarabah etc*. contracts so that they can meet the financing needs of their clients. Some of those modes could be used for financing sellers, while others could be used for financing buyers. Moreover, some modes could only be used for transferring usufruct/or benefit, while others are used for transferring ownership of real property and benefit as well. Another type is sharing between two parties, for which all of them provide capital and labour and will share profit and loss (Kahf and Khan, 1992). However, the current models feature a number of setbacks, most importantly the differences among Islamic banks in terms of formats of contracts, forms, procedures, legal documents and mechanisms of implementation of the relevant modes as individual practice varies from one bank to

another (Tariq, 2004; Ahmed, 2006; Lahsasna, 2014).It can be argued that the legal risks as well as the complexity of *sukuk* documentation could be eliminated by examining the terms and conditions of a typical *sukuk* contract (McMillen, 2006). In this regard, investors can only insure a smooth and applicable litigation process in case of a clear unambiguous contract.

7.2.13 The Lack of Application of IF Between Countries

The operations of IFBs from one country to another are neither harmonious nor consistent, nor are proper legal frameworks to deal with *sukuk* established in most countries (McMillen, 2006). This underlines the legal barrier to reduce the risk of diversity and uncertainty, which also reflects the lack of assurance of Islamic financial contracts. Even between orgnisations such as the International Islamic *Fiqh* Academy (ISFA) and AAOIFI, there are conflicts of interest (NuHtay and Salman, 2013). For instance, the SAC of the Securities Commission in Malaysia recognises some Islamic financial principles, which are not acceptable in countries such as those of the Gulf Cooperation Council and Pakistan. For example, *bai al-dayn* (date trading) is an acceptable principle for *sukuk* issuance in Malaysia, whereas it prohibited transaction in the GCC (Rosly and Sanusi, 1999).

7.2.14 The Applicability of *Shari'ah* in Non-Islamic Jurisdictions

Islamic financial institutions related disputes are still dealt either with the English law or continental civil law. However, in order to minimise legal risks, those who are working on *sukuk* structures should take into account the laws and the judiciary system the country that apply non-Islamic commercial laws (Ahmed, 2010). According to McMillen (2007), the idea of *sukuk* could make great progress in the presence of ratings, which are so far not available due to failure to secure satisfactory legal opinions regarding the applicability of *Shari'ah* in non-Islamic jurisdictions. Such legal barriers could be made less effective by standardising *Shari'ah*-based transactions as it has been discussed. Such measures could possibly alleviate risks featuring transactions through enforcing *Shari'ah* in a more consistent, predictable and transparent manner to the effect of facilitating integration of Islamic financial services into the global economic system (Hassan, 2012).

In the view of Jobst *et al.* (2008) *sukuk* structures must be made flexible as to accommodate both *Shari'ah* law as well as commercial law, as to overcome inconsistencies in non-Muslim countries. They further argue that the legal status of investors could become affected by lack of recognised standards with regard to *Shari'ah*, which could result in legal complications where *sukuk* are being involved. Nonetheless, adaptation of *sukuk*, which is *Shari'ah*-compliant, to a secular environment could be a difficult task to undertake. Therefore, as far as Islamic finance is concerned, combination between *Shari'ah* principals and Law always remains the main concern (Alamine, 2008). It is noteworthy that currently many transactions involving *sukuk* are governed by the English law while the associated assets remain under a different jurisdiction. This may lead to legal disputes in case of default. For instance, a court order in a foreign country might be ignored by the local authorities where the assets are based in case the transaction is rejected as being incompatible with *Shari'ah* law. Therefore, the diversity of laws covering the same contract would increase the potential of possible legal disputes between the various legislations involved. In fact, defaults which have already taken place in *sukuk* market have made the parties involved ending up at courts of law. A case in point is the default featuring East Cameron *sukuk* in 2008 (Khnifer, 2010)**.**

In this regard, Eltiby (2010) suggested that Islamic regulatory authorities such as AAOIFI and IFSB should provide guidelines for tuning with international standards for the sake of credibility of *sukuk* in the international arena, which can be argued for facilitating the enforceability *sukuk* contracts in different legal frameworks.

Another legal risk regarding the inconsistency of law is that, *sukuk* contracts have to satisfy the legal requirements of the national law as well as *shari'ah* law, which has made them subject to frequent scrutiny (Tariq and Dar, 2007). However, the main risk and problem is that foreign courts such as the case in the UK do not recognise *Shari'ah* law and that no compromise can be reached in that matter (Ercanbrack, 2014). It could be also argued that the lack of clarity in the enforceability of *sukuk* in different jurisdictions especially with regard to *sukuk* holders' rights over their assets as well as the conflict between the basses of *shari'ah* and the local law would lead to legal risks (Djojosugito, 2008). That is for the simple reason that neither the GCC

states nor any country in the world has invented a legal system that combines both *shari'ah* law and the local law (Abdel-Khaleq and Christopher, 2006).

Another risk pertaining to *sukuk* contracts is the possibility of sudden changes in the law before the *sukuk* expire, and that such change could happen at any time even before the contract comes into force, so that potential *sukuk* holders will be stuck in any dispute that might happen (Wedderburn, 2010). In this case however, the only way out for *sukuk* holders is the rescheduling of the debt to protect the investment, which is not a palatable option. Thus, in order to minimise the legal risks, investors have to make a careful scrutiny of the appropriate laws in a way that eliminates ambiguities as to minimise disputes (Tariq, 2004). From their part, lawyers have to work diligently in favour of *sukuk* holders featuring any potential disputes with issuers to the effect of giving them priority over other creditors in the event of issuers' bankruptcy.

7.2.15 The Conflict Between Western Law and *Shari'ah* Law and the Associated Risks

It could be argued that legal risks always occur when *Shari'ah* law becomes involved with traditional laws such as the British common law or civil law (Ahmed, 2006). Thus, in cases of disputes, the latter dominates so that contracts are interpreted as they are without taking the *Shari'ah* dimension into account. A case in point is '*Shamil* Islamic Bank of Bahrain vs. Pharmaceutical Company', in which case, the company failed to pay the bank as a financier, and the court judgment was issued based on the British law instead of *Shari'ah* law. Yet, in his presentence report, the judge ruled out the idea of the same contract being governed by more than one system of law, so that he opted for the British law which was based on the Roman conventions (Potter 2004).

However, problems associated with civil law have featured in the recent case involving *Nakheel sukuk*. Following default of *Nakheel sukuk* confusion occurred as to the appropriate law to be implemented as the company's regulations were based on the British law, while the *sukuk* transactions took place in a civil law jurisdiction. That inconsistency nonetheless, has caused confusion in Dubai's civil courts where the case has been seen. The alternative for investors to sue the company was the British courts, but in that case the court order could not be enforceable in the UAE, and that

seizure of the company's assets would be unlawful (Kasolowsky and Abocar, 2009). Thus, in contradiction with the original contracts, investors' rights had been restricted due to the conflict of laws.

From a legal point of view, however, it could be maintained that with respect to *sukuk* contracts, *Shari'ah* law is more or less straight forward with the due flexibility to accommodate the local law (Abdel-Khaleq and Richardson, 2006). However, problems might occur with regard to law enforcement when it comes to cross-border transactions. That is particularly so with regard to assets sales between originators and investors via SPV as well as matters involving bankruptcy, where confusion occurs in the system of law to be enforced in relation to *sukuk* contracts (McMillen, 2007).The inconsistency and poor coordination between laws governing *sukuk* contracts may have direct effects on the rights of *sukuk* holders. Therefore, as far as *sukuk* contracts are concerned, the enforceability of a court order mainly depends on whether that order is based on the law of the country where that court is located (Howladar, 2006).

7.3 PERSPECTIVES OF THE PARTICIPANTS ON THE STRUCTURE AND PROSPECTUS OF SABIC *SUKUK*: INTERVIEW ANALYSIS

In an attempt to provide a critical understanding of the identified issues in the SABIC *sukuk*, it is essential to have a data collected through interview survey from the field with those who are specialised in the legal side of Islamic finance especially *sukuk* such as lawyers, judges of *Shari'ah* courts, researchers and academic staff. As mentioned in the research methodology chapter, a number of interviews were conducted and the material presented in this chapter is the outcome of a thematic and textual analysis of the data collected from those interviews. It should be mentioned that each of the following sections based on questions that were presented to three legal specialists of *sukuk* with regard to particular legal issues in SABIC structures and prospectus, which are based on the above identified risk areas.

7.3.1 Perceptions on the Need for a Law or Special Legislation Relating to SABIC and other *Sukuk* in the CMA

Interviewees 9, 10 and 11have maintained that all rules and regulations that have been issued by CMA including the Offers of Securities Regulations, Listing Rules *etc*. do not feature systems or laws especially targeting *sukuk*; however, instead all that exist are regulations and laws in relation to stocks and debt instruments. According to all

the Interviewees, it seems that no difference is made between *sukuk* and bonds in the rules and regulations that have been issued by the CMA so that the two systems are mixed up. In this regard, the Interviewee 9 has confirmed that as far as the CMA is concerned *sukuk* are no longer appreciated by the system as an independent product; however, instead SABIC *sukuk* are considered as securities similar to shares and bonds. In addition, he argued that this implies that *sukuk* for CMA is only the hybrid product of the capital markets. In the meantime, the Interviewee 10 pointed out that all companies that have issued *sukuk* including SABIC have legally relied on the laws and regulations that regulate the issuance of shares and bonds, while the Interviewee 11 stressed the fact that the lack of special legislation for *sukuk* featuring the CMA has not prevented the companies that show interest in *sukuk* such as SABIC to issue their own *sukuk* by relying on laws and regulations that do not include *sukuk* systems.

From the responses identified above the following can be concluded:

(i) *'Sukuk* term' has not featured in any special legislation issued by the CMA. In other words, all systems and laws issued by CMA have stopped short of referring to *sukuk*;

(ii) The companies that have been involved with *sukuk* included SABIC company have relied on the already existing legislations issued by CMA featuring securities.

7.3.2 Questioning the Legal Authority Dealing with Disputes and Insolvency in Relation to *Sukuk*

In the second stage, all the interviewees were requested to express their opinions on the legal authority that deals with disputes and insolvency in relation to *sukuk*. Indeed, the question relates to the fact that whether such an institution exists or not.

All those who have been interviewed responded by pointing out that the prospectus of issuance of all *sukuk* including SABIC *sukuk* provide that the Committee for the Resolution of Securities Disputes (CRSD) and the Appeal Committee for the Resolution of Securities Conflicts (ACRSC) are the only legal authority to investigate and solve cases involving investors within the rules of the CMA as well as its executive regulations and the associated rules, including, for instance, the potential dispute between *sukuk* holders and the issuer. However, according to the Interviewee 9, the normal procedure is that any dispute should be dealt with by *Shari'ah* courts,

and yet in Saudi Arabia some disputes have been excluded to be dealt with by special panels which some consider as administrative, as the members of those panels do not have enough knowledge with *Shari'ah* rules, while some consider then as semi-judiciary panels due to similarities between them and *Shari'ah* courts with regard to commitment to the rules and imposition of punishment. In this respect, the Interviewee 10 stressed the fact that apart from being linked to *Shari'ah* or not, the activity of the CRSD and ACRSC are purely legal, and that the real undeclared aim behind the establishment of the two committees is to investigate matters in relation to potential disputes featuring the financial securities market. However, securities market in some aspects involve *riba*-based transactions, in which case *Shari'ah* courts most likely decline judgment featuring contract based on *riba* in which case the contract is considered invalid from the beginning. As for that reason, a royal decree issued for establishment of two committees to deal with matters involving disputes instead of *Shari'ah* courts where the judges of those courts investigate the nature of the contracts. If investigations prove that *riba* is involved, they render the contract invalid keeping a blind eye on any disputes involving the contract. As for the Interviewee 11, he believes that the disputes involving *sukuk* should be a matter for specialised *Shari'ah* courts, and yet the main reason behind the CRSD and ACRSC is the absence of specialised commercial courts in Saudi Arabia.

From the responses shown above the following conclusions can be drawn:

(i) The CRSD and ACRSC are considered as a legal judiciary authority with regard to SABIC *sukuk*;

(ii) The above two committees are excluded from being under the authority of *Shari'ah* courts;

(iii) Disagreement exists as to the reasons behind the establishment of those committees.

7.3.3 Perceptions on the Consistency of *Fatwa* Validating SABIC *Sukuk* and its Non-Binding Nature for CSRD and ACRSC

In this section, the interviewees were requested to express their views from a legal point of view as to how they see the *fatwa* that approved SABIC *sukuk* while it is considered a non-binding *fatwa* for CRSD and ACRSC.

The Interviewee 9 responded by saying that the prospectus of issuance of SABIC *sukuk* provides that *Shari'ah* courts as well as CRSD and ACRSC show no commitment to the decisions made by the SBSS. However, that matter is considered among the legal risks that face *sukuk* holders in case of bankruptcy or insolvency of the issuer. As for the Interviewee 10, he pointed out that SABIC *sukuk* holders could be aware of the fact that the *fatwa* made by SBSS in relation to SABIC *sukuk* had been inapplicable, and that *Shari'ah* courts as well as the CRSD and ACRS would show no commitment to those *fatawa*. However, as yet *sukuk* holders might have been unaware of the potential legal risks resulting from failure to show commitment to the *fatawa* to be made by SBSS. The Interviewee 11, on the other hand, made it certain that the court system in Saudi Arabia and the semi-judiciary panels such as CRSD and ACRSC are independent, and that it is impossible for SBSS or any form of securities activity to make them committed to their decision regarding cases to be investigated by *Shari'ah* courts or the CRSD and ACRSC, given that failure to make the semi-judiciary panels that investigate such *sukuk* cases to follow the *fatawa* issued by the SSB might lead to conflict between two legislative authorities. In other words, the SBSS will be meaningless during the fact the *fatawa* they issued could be not recognised by the *Shari'ah* courts or otherwise by the members of CRSD and ACRSC as being inconsistent with *Shari'ah* principles.

From the responses discussed above the following inferences can be made:

(i) Having neither *Shari'ah* courts nor the CRSD and ACRSC show commitment to the *fatwa* on which *sukuk* is based in terms of *Shari'ah* is considered among the legal risks that might render *sukuk* invalid;

(ii) In order to enhance legal status of SBSS, the *fatawa* issued by them should be binding and obligatory.

7.3.4 Perceptions on the Legal Status of CRSD and ACRSC

The participants were asked for their opinion as to whether the CRSD and ACRSC are similar to *Shari'ah* courts in terms of the legal power, and considered independent in their judgments. In other words, they were asked to express their opinion on the legal status of the two committees.

The Interviewee 9 has made it certain that the CRSD and ACRSC -that have been authorised to investigate cases involving securities in the Saudi capital market including SABIC *sukuk* - are two independent panels practicing their activities as a judiciary entity featuring securities disputes with the due neutrality and honesty, and that nobody whatever his status can influence the course of the cases where the two panels are involved, and that the two committees are not in any way subject to the influence of the CMA. In this regard, some decisions made by CRSD and ACRSC against deferent cases which CMA supported that indicates the degree of independence and neutrality of those committees. While the Interviewee 10 mentioned that the places where justice can be upheld are so numerous that sometimes causes confusion to lawyers and specialists. In other words, places where justice can be exercised are so diversified that it includes numerous government and judiciary institutions making the system of Saudi Arabia different comparing to other countries. The authorities concerned with disputes fall under three main categories which are either the public judiciary courts, the administrative courts (Board of Grievances), or the administrative panels (Boards) of judiciary nature which are in excess of 70 panels or board, where every panel has its own discipline in terms of its specialisation and rules featuring a royal decree in relation to sorting out disputes resulting from the implementation of the rules of that discipline as an exceptional case from the public judiciary and administrative courts.

Despite the fact that a previous Royal Decree had been issued in 2007 ordering the review of those panels to pave the way for integrating them with the public judiciary courts or with the administrative courts or otherwise some might continue as an exceptional case. However, in practice those panels have yet to change in terms of reality and functioning particularly following the approval of the new judiciary system in Saudi Arabia.

The Interviewee 10 also highlighted the importance of the origin of the judiciary independence, which is a genuine principle in terms of *Shari'ah* not to mention the fact that it features in most constitutions in the world. In this respect, that principle featured in Article 46 of the Constitution of the Kingdom clearly provides that the judiciary is an independent authority, and that the judges of the courts are only overpowered by *Shari'ah* law. In its simplest meaning, the independence of the

judiciary authority should keep its independence from the legislative power and the government so that those powers should be kept away from interfering with the judiciary or otherwise have control on their activities by any means.

There have, however, a lot of controversy over the status of those administrative committees and the extent to which it offends the principle of the judiciary independence, particularly those panels whose decisions are considered final and obligatory before the administrative courts such the CRSD and ACRSC those have been approved by the regulation of the CMA featuring the Royal Decree No. (M/30) on July 1st 2001 in terms of its formation, definition of its powers and function. As they considered the authority to investigate cases of disputes involving *sukuk* including SABIC *sukuk.*

Furthermore, Interviewee 10 argued that the issue of exception of a number of functions from public and administrative courts in favour of administrative panels (CRSD and ACRSC) which are formed from government staff rather than *Shari'ah* judges to issue decisions to sort out disputes with the power of the judiciary rulings. He also identified that they have the same authority as the public courts, which remains a controversial matter particularly with regard to the inconsistency of the matter with the principle of the independence of the judiciary power and the Saudi constitution which is inspired by the principles of *Shari'ah*. The main problem is that the members of CRSD and ACRSC are not *Shari'ah* judges so that it becomes questionable that they become entrusted with the job of sorting disputes between parties and impose punishment on the perpetrators. In addition, among the inconsistencies is the formation of the money exchange dispute relating arbitration panel particularly the inconsistency of Article 25 of the financial market regulation with the constitution which stipulates that the CRSD and ACRSC will be established by the CMA to be entrusted with cases involving disputes that fall within the jurisdiction of this discipline and its executive regulations as well as the regulations of the authority and the market and their rules and directives including public and private matters. The CRSD and ACRSC have all the necessary powers with regard to investigating and sorting out of cases, including the power to call witnesses, make decisions, impose punishments, and order the presentation of evidence and document

etc. The members of the CRSD and ACRSC will be appointed by a decision to be made by the council *i.e*. the council of the CMA for three years subject to renewal.

The inconsistency with the constitution in this case as the Interviewee 10 mentioned is that the appointment of the members of the two committees is a matter for the CMA council, and in the meantime the CMA *per se* is entrusted according to the constitution to make cases against those who offend public order and the associated executive regulations. For instance, it is not reasonable that the CMA makes a case involving public right featuring SABIC *sukuk, f*or example, which is the case in point, for offending the CMA system to be investigated by CRSD and ACRSC whose members are appointed by the same authority that has made the case. In other words, how can the CMA become a plaintiff and a judge at the same time in case of failure of *sukuk* issuer to live up to its promises? That represents a conflict of interest and makes the principle of dependence questionable. In addition, that will raise doubts and accusations that the decision to be made by the CRSD and ACRSC will most likely be in favour of the CMA, as it has appointed the members of the panel. That becomes clear given the fact that Article 13 of the CMA regulation stipulates that the financial resources of the CMA feature a number of sources including fines and financial punishments to be imposed by CRSD and ACRSC on the offenders of the rules of the CMA so that by making cases involving public right, the CMA will benefit directly from cases where offenders are to be found guilty as it is the direct beneficiary of the money to be paid by those offenders that might reach tens of millions of SR for a single offender. In this regard Article 59 of the CMA regulation refers to the following penalties that "In case the CMA realizes that any person has taken part; will take part or about to become involved in activities or practices in offence of any of the jurisdiction of this discipline or the rules and regulations to be issued by the authority or the regulations of the market, then in that case the CMA preserves the right to make a case against him before the CRSD and ACRSC seeking a decision to impose the suitable penalty as the potential penalties include the following: compensation for those suffering from the damage inflicted on them as a result of the offence being committed, or otherwise forcing the offender to payback the material benefits he has made by committing the offence into the account of the authority".

Interviewee 10 also noted that the legislator stipulated in the Article 13 of the CMA regulation that those who suffer from damage as a result of the offences should either receive compensation or otherwise the offender should be forced to pay back the financial rewards has achieved from committing the offence in favour of the CMA. However, despite the fact it is technically possible to consider all those who have suffered from damage due to the offences made by the guilty person as well as estimating the damage inflicted of every one of them, and yet by reviewing all the cases made by the CMA before the CRSD and ACRSC in relation to the public right will discover that the CRSD and ACRSC have been focused only on its demands of the offender to be forced to pay back the benefits in favour of the CMA. However, according to the published decisions of the CRSD and ACRSC, there is no precedent that the panel has demanded the compensation of individuals who has suffered from damage that has been caused by committed offenses. That indicates beyond doubt the direct convenience in favour of the CMA by making cases involving public right. That result should definitely put the CRSD and ACRSC at risk in terms of independence and neutrality as its members are appointed through selection by the council of the CMA, and decision to continue or otherwise terminate that membership made by the same council. For that reason, given that situation it is impossible to assume the independence of the CRSD and ACRSC.

In further reflecting on the independence of CRSD and ACRSC, Interviewee 10 continued to argue that independence of any organization is a matter of definite constitutional stipulations rather than a matter of statements and assumptions to be made by government officials. It is impossible to believe that independence being appointed by a government body that benefits directly from the decisions to be made by those panels. Moreover, the fact the panel headquarters is based within the premises of the CMA not to mention the fact that its members receive monthly bonuses in return for their membership at the expense of the budget of the authority should put the independence of those panels in doubt. For that reason, it becomes obvious that Article 25 of the Financial Markets appear to be inconsistent with the principle of independence of the judiciary authority provided for by Article 46 of the Constitution. Thus, in case such provision exists in any of the constitutions in the world, it becomes legally feasible for those affected to challenge that stipulation before the appeal court for repealing that article for being unconstitutional. However,

the satiation in Saudi Arabia still remains ambiguous. Is it possible to challenge Article 25 of the CMA regulation as being unconstitutional and call for its repeal or otherwise its amendment before any court?

In his criticism, Interviewee 10 also reflected that no constitutional court exists in Saudi Arabia similar to courts in other countries in terms of legal practice. However, according to the judiciary regulation and administrative courts, namely the *Diwan al-Mathalim* or Board of Grievances, regulation issued in 2008 for the establishment of a high court and administrative court featuring the public judiciary and administrative judiciary respectively. However, those courts stop short of the description of the constitutional court as either of them is a high appeal court that reviews the decisions be made by the appeal courts in terms of application of *Shari'ah* law and the decrees to be issued by the King. Therefore, as stated by the Interviewee 10, as long as neither the supreme court nor the high administrative court is concerned with investigating cases in relation to the constitutionality of any article featuring regulations to be issued by royal decree, then in such a case, we have to consider the following questions: what if one of those affected makes a case against the decision made by the CRSD and ACRSC by challenging the constitutionality of its formation, *i.e.* the violation of Article 25 of the CMA regulations to the constitution, and whether the administrative court will accept to investigate the case? The answer will be negative as the administrative courts has nothing to do with cases associated with that panel as an exceptional case based on the regulation issued by a royal decree featuring the CMA regulation and that issuance is related to the sovereign power of the state which cannot be overruled by the power of the administrative courts according to the rules of the Board of Grievances.

Therefore, the only reasonable legal solution available is the amendment of Article 25 of the CMA regulation so that the members of the CRSD will be appointed by a decision made by the Council of Ministers in a manner similar to the formation of the ACRSC whose members are being appointed by a decision made by the Council of Ministers as being provided for by paragraph Z of that article.

Finally, in case the method of executing the judiciary system and the Board of Grievances has stipulated the exception of the panels of the CMA from the umbrellas of the administrative and public courts, then that exception should not be extended to

include the exception of that panel from the principle of the judiciary independence by the continuation of interference of the CMA (the executive body) in the appointment of the members of the panel (the judiciary body). This implies that the judiciary independence is a constitutional principle which becomes meaningless unless it has been practiced.

Finally, Interviewee 11 pointed out that the CRSD and ACRSC have direct independence with regard to practicing its duties, and that the CMA regulation has stipulated in Article 25. Accordingly, it is expected that special bodies should be entrusted with cases involving securities disputes in court, and those should have full independence in making decisions and issuing rules that it deems consistent with the nature of the appropriate systems and regulations to be issued. In addition, according to the constitution it has become the body to investigate cases involving disputing parties including investors, financial mediation companies as well as the organising and executive bodies of the CMA.

From the above presented analysis of the responses provided by the interviewees, the following conclusions can be drawn:

(i) The interviewees seem to be in disagreement regarding whether or not the decisions to be made by the CRSD and ACRSC should be independent from the CMA;

(ii) The fact that numerous bodies exist to investigate cases might lead to legal problems as well as risks;

(iii)The CRSD and ACRSC are the legal entity to investigate cases involving disputing parties as being stipulated by the constitution;

(iv)The dependence of the panel becomes a requirement in terms of the law and *Shari'ah*;

(v) Differences in opinion exist among the interviewees with regard to the nature of the panel as being administrative with legal powers or being a judiciary panel;

(vi)Some call for the real independence of the CRSD with regard to the body to be entrusted with the appointment of its members;

(vii) Some call that the CRSD should be affiliated to the judiciary so that cases of disputes should be a matter for *Shari'ah*-related commercial courts.

7.3.5 Perceptions on the CRSD and ACRSC's Power for their Decision to be Abiding and Executable

The interviews were asked to comment on the as to whether the CRSD and ACRSC have the power for their decision to be abiding and executable; and their opinions are analysed as follows:

The Interviewee 9 responded by referring to the fact that both the CRSD and ACRSC are concerned with investigating cases of disputes that take place within the context of the jurisdiction of rules of the CMA and its regulations as well as the regulations of the authority and the market and their rules and directives regarding the public and private rights including any dispute that takes place between *sukuk* issuers and *sukuk* holders as the case with SABIC for instance. However, he argued that, the decision of the CRSD and ACRSC are enforceable and be abiding to all parties involved in the dispute given those who show dissatisfaction with the decision of the CRSD have the right of appeal as to the review the verdict against him. That could be done by complaining against the decision to the ACRSC which is higher than the CRSD and can overrule the decisions made by the CRSD, confirming those decisions or otherwise review or reconsider the case as appropriate based on the information provided by the CRSD and makes the right decision in the case. However, the decisions to be made by the ACRSC are irreversible and abiding.

The Interviewee 10 reflecting on the issue through a different perspective stated that apart from legality of the case involved, the activities of the panel should purely legal in nature. However, while the state constitution provides that it should be Islamic inspired by *Qur'an* and *Sunnah* involving jurisdiction in accordance with *Shari'ah*, and yet that raises the question as to how some cases of securities involving *riba*-based transactions that offend *Shari'ah* principles should be investigated by the CRSD and ACRSC? Is it for the only reason that it has been approved by the regime featuring systems and regulations? So it could be said that those panels are approved by the CMA rules rather by *Shari'ah* law, therefore it is supposed that the constitution should not stipulate to make the CRSD and ACRSC investigate cases of dispute by making its decisions binding to the disputing parties. However, in that case the CRSD

and ACRSC will become a legal entity similar to *Shari'ah* court. Interviewee 10 further argued on the idea that the judiciary must be linked to *Shari'ah* by stating that these two committees are not being linked to *Shari'ah* law as its members are law-trained rather than *Shari'ah*-trained judges. Bearing those facts in mind, the main duty of the CRSD and ACRSC should be to bring together the disputing parties for compromise; otherwise, the case should be referred to the appropriate court for investigation. In other words, failure of the panels to reach a compromise to the satisfaction of the disputing parties should mean the case should be referred to the relevant court for investigation.

In contrast, the Interviewee 11 stressed that the CRSD and ACRSC and other relevant committees established due to the lack of specialized legal commercial court, and the lack of specialized commercial courts is one of the risks that threaten the *sukuk* market as well SABIC *sukuk* in the Saudi market. He then added that these committees are not *Shari'ah* based and not legitimate judges, they do not derive provisions of *Shari'ah*, but applied in the Western courts of law and this violates stipulated in the prospectus and in the instruments of SABIC that 'SABIC *sukuk* are subject to the regulations in force in Saudi Arabia, according to Islamic law'.

As for the Interviewee 11, he has also explained that the CRSD and ACRSC might have been a necessity for the state in the past. He, however, stated that now in the aftermath of the development and promotion of the markets of Islamic finance there will be no need for them to continue; as he argued that its time for those panels whose jurisdiction is neither final nor binding to be replaced by *Shari'ah* courts specialised in cases involving securities including *sukuk* and the judges should highly trained on legal, financial, and *Shari'ah*-related matters.

From the responses of the interviewees the following conclusions can be drawn:

(i) The cases involving securities including *sukuk* feature two levels; first reporting the case to the CRSD and second; making the appeal to the ACRSC in case of dissatisfaction with the decision;

(ii) The decisions made by the CRSD are not binding and challengeable before the ACRSC whose decision is binding and irreversible;

(iii) Differences exist among the interviewees regarding validity of the panel in *Shari'ah* terms as it does not include *Shari'ah*-trained members.

7.3.6 Perspectives on the New Judiciary System Responsible for Cases of Securities Disputes including SABIC *Sukuk*

The interviewees were asked to comment on the new judiciary system in terms of defining the body that is responsible for cases of securities disputes including SABIC *sukuk.*

All those who were interviewed are of the opinion that the new judiciary system in Saud Arabia that has been established in accordance with the Royal Decree No. 87/M dated 1429 H, has excluded the CRSD and ACRSC as well as other panels to keep administrative panels with judiciary powers away from the umbrella of the public and administrative judiciary system. In other words, they pointed out that the new judiciary system has made those two panels independent of the judiciary.

In this regard, the Interviewee 9 argued that the new judiciary system made the CRSD and ACRSC as two bodies to be referred to in cases of disputes involving securities including *sukuk*. However, having said that it would have been more appropriate for those two panels to become part of the specialised commercial panels as the case with other semi-judiciary commercial panels that have been transferred to remain under the authority of the public and administrative judiciary. However, such transfer will secure the enforcement of decision to be made by those semi-judiciary panels besides making the link between those panels and judiciary even closer.

The Interviewee 10 has made the point that the judiciary system in Saudi Arabia needs to be reviewed, as it seems to be inconsistent with the general rules that organise the judiciary so that it offends the unity of the judiciary. Ideally, it is preferable that the judiciary should belong to one body featuring the Ministry of Justice without being disputed by the Ministry of Commerce or the financial market authority, and the claim that those panels are judiciary organisations but rather more of administrative panels are not true. The fact that they have power to impose fine and detention should falsify those claims, and that the latter is a unique power of the judiciary. Moreover, the cases to be investigated by those panels are extremely important to the national economy.

Thus, the Interviewee 10 argued that the existence of panels and authorities to be entrusted with the investigation of cases associated with securities disputes as independent entities of *Shari'ah* courts should be the main reason for the poor enforcement of decisions made by those panels. He argued that this should be for the simple reason that some perceive those panels as non-judiciary bodies, but rather administrative bodies whose decision are not binding. On the other hand, the ramification of procedures associated with those panels also has negative effects on the enforcement of decisions.

The Interviewee 11 argued that the new judiciary system has yet to have control overall legal conflicts and disputes in Saudi Arabia, as many cases of disputes still remain out of the authority of *Shari'ah* courts indicating that some legal conflicts remain excepted from the jurisdiction of *Shari'ah* law. In particular, cases of conflicts and disputes associated with securities are considered beyond the remit of the *Shari'ah* law, as in such cases, the members of the panels involved are not *Shari'ah*-trained, even though its activities are purely legal with no consideration to the case as being consistent or not with *Shari'ah* principles as there is no sign for that in the law and regulations of CMA. However, the body to investigate cases involving securities including SABIC *sukuk* is supposed to be *Shari'ah*-linked commercial courts with judges to be trained in both *Shari'ah* law and civil law.

Based on the above presented interpretation of the interview material, the following can be concluded:

(i) The CRSD and ACRSC are still excluded by the new judiciary system in Saudi Arabia from being integrated in the system;

(ii) The dependence of the CRSD and ACRSC tends to make their decisions less forcible;

(iii) The establishment of *Shari'ah*-based commercial courts becomes a necessity;

(iv) From a legal perspective what is the legal impacts of the different *fatawa* made by *Shari'ah* scholars in various matters in relation to SABIC *sukuk*?

7.3.7 Perception on the Effect of the Differences in *Fatawa* between the *Shari'ah* Committee of SABIC *Sukuk* and the Members of CRSD and ACRSC on Various Matters

From legal point of view, the interviewees were invited to comment on the effect of the presence of the differences in *fatawa* between the *Shari'ah* committee of SABIC *sukuk* and the members of CRSD and ACRSC on various matters.

The Interviewee 9 responded by pointing out that the CRSD and ACRSC, which are the relevant legal body in case of disputes involving SABIC *sukuk*, make their judgments in accordance with the Saudi legal system and the principles of Islamic *Shari'ah*. This implies that the Saudi legal system and *Shari'ah* principles should provide a reference framework for the CRSD and ACRSC so that the members of the panels have no chance to deviate from that.

The Interviewee 10 on the other hand stressed the fact that lack of awareness between the members of the CRSD and ACRSC of the various approved *fatawa* on financial transactions could be among the risks facing SABIC *sukuk*. In general, certain well known differences in relation to financial transactions do exist among *Shari'ah* scholars since the old times. Having said that, the *Shari'ah* board of SABIC *sukuk* could be of an opinion that could contradict the opinion held by the CRSD and ACRSC which would eventually affect the *sukuk* in legal as well as *Shari'ah* terms. In other words, the *sukuk* could be legally valid in accordance with the regulations issued by the CMA, and yet it could be in disagreement with *Shari'ah* principles, indicating inconsistency between the legal and *Shari'ah* aspects.

The Interviewee 11 made it clear that among the legal risks associated with the securities in the CMA including SABIC *sukuk*, is the possibility that *sukuk* might not be subject to execution by *Shari'ah* courts and the judiciary panels. This could be for the simple reason that the *Shari'ah*-based structure of SABIC *sukuk* is not binding for CRSD and ACRSC in case of conflict between the issuer and *sukuk* holders. That should mean that the differences in opinion between SBSS and the members of the CRSD and ACRSC in *Shari'ah* terms might lead to the invalidation of *sukuk* in legal terms and failure of the relevant contract.

From the interviews analysis provided in this section, the following conclusions can be inferred:

(i) The *Shari'ah*-based differences among the members of CRSD and ACRSC as well as SBSS in *Shari'ah* terms is considered among the risks that threatens the legality of SABIC *sukuk* and the application of the relevant contract;

(ii) Failure to make *Shari'ah*-based *fatwa* made by SBSS binding tends to render SABIC *sukuk* an unpopular financial paper in *Shari'ah* terms.

7.3.8 Perception on the Legal Risks that SABIC *Sukuk* might be Exposed

This section focuses on the legal risks SABIC *sukuk* might be exposed taking into account a number of issues and aspects discussed below in relation to the opinions conveyed by the interviews;

7.3.8.1 The prospectus of issuance

Interviewee 9 responded by arguing that the prospectus of issuance is considered among the most important documents that should be taken into account whether by the CMA which is the official body that controls the issuance of *sukuk* and the circulation of the money exchange including SABIC *sukuk*, or by the issuer and *sukuk* holders that represent the contracting parties so that any legal or *Shari'ah*-linked problem might render *sukuk* invalid, and might lead to the squandering of rights only for the parties involved to indulge in conflict and dispute. For that reason, the prospectus of issuance must include an accurate description of the contracting relationship between the parties involved by naming the *Shari'ah*-based contract featuring the issuer and *sukuk* holders, and also the rights and duties undertaken by the various parties. The Interviewee 9 also made the point that in case of SABIC *sukuk* the relationship between the issuer of SABIC *sukuk* and *sukuk* holders was not clear beyond doubt, but instead a generalised rather than detailed description is given by the prospectus of issuance.

The Interviewee 10 agreed on the argument made by the Interviewee 9 with regard to mentioning the name of the contract and defining the parties involved in the contract. In addition, he added that the prospectus of issuance must clarify the nature of the assets to be sold by the issuer to *sukuk* holders and that the selling process has to

satisfy all conditions legally as well as in *Shari'ah* terms as provided by the judiciary systems in Saudi Arabia with regard to legal documentation featuring the transfer of assets from the register of the issuer to go to the register of the holders. Nonetheless, in most cases involving *sukuk*, confusion is being made between assets-based *sukuk* and assets-backed *sukuk* given that a big difference between the two in legal terms. Interviewee 10 adds that by reviewing the prospectus of issuance of SABIC *sukuk*, it seems that the contractual relationship between the issuer and the holders is unclear, and whether the *sukuk* to be sold to *sukuk* holders have legal base that makes the selling process and transfer of *sukuk* from the issuer to the holders a possible matter. In addition, he mentioned that the prospectus of issuance has stopped short of explaining the method of evaluation of the assets that have been sold.

In a functional manner, Interviewee 11 agreed that the prospectus of issuance had to feature all the rights, duties and the rules that had to be applied as well as the potential legal and *Shari'ah*-related risks involving *sukuk*, and that matter had been, to a great extent, missing in relation to SABIC *sukuk*.

From the above analysis based on the answers provided by the interviewees, the following can be drawn:

(i) It becomes a necessary matter that the prospectus of issuance should feature all information needed by CMA and any other parties involved such as *sukuk* issuers and *sukuk* holders;

(ii) CMA is supposed to be the body responsible of any improprieties featuring the prospectus of issuance regarding failure to implement the financial systems of the market or otherwise failure to cope with *Shari'ah* principles;

(iii) The faulty and incomprehensive information available in the prospectus of issuance considered one of the legal risk not to mention failure to refer to legal and *Shari'ah*-related risks might any *sukuk* issuance be exposed and the impacts that follow is also considered as a risk.

7.3.8.2 The relevant documents and papers

In relation to the relevant documents and papers creating legal risks, Interviewee 9 mentioned that reviewing all the documents and the papers featuring any *sukuk*

issuance is an important matter, so that the CMA has to make sure it is legal and safe in terms of organization. Otherwise, *sukuk* might be rendered invalid in terms of consistency with CMA systems. The Interviewee 10, on the other hand, confirmed that those documents and papers should be accessible to everyone and that *sukuk* holders should be exposed to documents and information in relation to *sukuk* they intend to buy, or otherwise it might not be safe for *sukuk* holders to make legal claims due to lack of information that is available to them. The Interviewee 11 made it clear that the CMA most likely considers the documents and papers in terms of organisation and consistency with the systems and regulations of the CMA apart from its validity from *Shari'ah* perspective. Eventually, that could make *sukuk* and the associated documents safe in terms of CMA regulations, which could be associated with some problems in *Shari'ah* terms exposing *sukuk* to some legal problems such as being less effective. Therefore, *sukuk* should be considered from both the legal aspect as well as *Shari'ah*-related aspect.

From the analysis of the interviews presented in this section, the following can be concluded:

(i) Given that it is necessary for CMA to focus and review the prospectus of issuance, the authority is also required to review all the relevant documents and papers as to make sure that those documents are easily accessible to *sukuk* holders;

(iii) CMA also has a duty to make sure of the validity of the prospectus issuance as well all the documents and papers in terms of compliance with CMA rules, which should imply the accurate examination of those documents as dictated by *Shari'ah* as to avoid any differences and inconsistencies between those documents and the opinion of the he members of CRSD and ACRSC in *Shari'ah* terms.

7.3.8.3 *Sukuk* holders

As regards to the legal risks exposed in relation to *sukuk* holders, Interviewee 1 responded that *sukuk* holders are more exposed to the legal risks associated with *sukuk* than any other of the parties involved. In other words, rendering the *sukuk* legally invalid should mean the loss of right and probably the assets owned by *sukuk* holders. For that reason, *sukuk* holders have a duty to make sure that their legal rights are secured in relation to their ownership of the assets they have bought, and that

those assets have been transferred to them in real and have been moved from the register of the issuer to the register of *sukuk* holders.

Interviewee 10 on the other hand pointed out that the legal risks to which *sukuk* holders might be exposed feature the vagueness of their legal attitude in relation to the judiciary bodies. The question is as to whether *sukuk* holders will be considered by the CRSD and ACRSC as real owners of the assets they have bought from the issuer or whether they be treated as debtors? That should mean that they would be treated similar to bond holders, for the simple reason that the legal status of *sukuk* holders is unclear for a number of reasons including the fact that special law featuring *sukuk* is non-existent in Saudi Arabia to help to differentiate between *sukuk* holders and bond holders in terms of legal status, not to mention the fact that no precedents exist with regard to the cases that have been investigated by CRSD and ACRSC to provide a hint on the way to deal with *sukuk* holders in their capacity as real owners of the assets they have bought or otherwise to be treated as creditors similar to bond holders.

In addition, Interviewee 11 noted that most of the investors in *sukuk* in the Saudi market belong to major companies that have sufficient staff of specialists in legal matters to look into securing the legal rights for those companies. They becoming involved in buying *sukuk* provide proof that they feel safe to become involved in such securities investment. However, the source of safety could be due to their access to legal documents through which they can prove the warrantee given to them by the issuer for their capital as well as the profit to be made apart from any other issues that could be considered in the opinion of those major companies as minor and not worth attention.

From the analysis of the interviews provided above, the following conclusions can be drawn:

(i) *Sukuk* holders are the most vulnerable of the parties involved to any potential legal risks;

(ii) In the real sale and the transfer of assets from the issuer to *sukuk* holders, the procedures should be made consistent with the judiciary system and *Shari'ah* principles, which should be the main concern of *sukuk* holders;

(iii) The fact a special law featuring *sukuk* is non-existent in Saudi Arabia might have led to some ambiguities in the legal status of *sukuk* holders;

(iv) A major controversy exists among legal experts regarding the legal status of *sukuk* holders as to whether they are considered real owners of the assets that they have bought or otherwise the relationship between them and the issuer is that between a creditor and a borrower similar to that between the issuer and the holder in case of the traditional bonds.

7.3.8.4 SPV

In relation to the legal risks originating from SPV in *sukuk* structure, Interviewee 9 has responded by arguing that private companies mainly aim at keeping the assets to be sold by the issuer to *sukuk* holders within a legal entity that is completely independent from the issuer that keeps the rights of *sukuk* holders away from the issuer. However, the system of establishing commercial companies in Saudi Arabia is still associated with many complexities and challenges that could consume time as well as money, and that would make the process of issuing *sukuk* highly costly compared to the traditional bonds which do not need such SPV to become involved. Consequently, the companies that seek funding would prefer the traditional bonds over *sukuk* for reasons of low costs of issuance. Issuing *sukuk* need the establishment of SPV which is costly as the issuer has to which have to meet all the . The same could be said about investors in securities who go for the traditional bonds rather *sukuk* as the former would generate high returns given the inverse relationship between the costs of issuance and the returns on securities. In addition, Interviewee 10 makes it certain that due to the fact that a law featuring *sukuk* is non-existent in Saudi Arabia, which implies that the process of establishing private companies has to cope with the special systems with regard to establishing shared companies whose systems are complex and cost prohibitive for the issuer as has been pointed out by the Interviewee 9.

However, Interviewee 11 has agreed to the above opinions, and yet he has argued that the SPVs have not satisfied the legal aims with regard to their establishment in relation to keeping the assets to be sold by the issuer to *sukuk* holders. In other words, those SPVs should constitute part of the issuer assets and in most cases should be given the same name of the issuer company as an indication of the transfer of assets

from the issuer to SPV even though the condition might have not been fully satisfied with regard to such transfer.

The following conclusions can be drawn from the analysis of the interview data presented in this section:

(i) A special law for establishing private companies (SPV) is non-existent in Saudi Arabia particularly in relation to matters associated with the issuance of *sukuk*;

(ii) The private companies (SPV) have failed to keep the assets away from the issuer in favour of *sukuk* holders.

7.3.8.5 Bankruptcy law

Regarding the bankruptcy law leading to legal risks for *sukuk*, Interviewee 9 explained that in case SABIC company going bankrupt or insolvent for instance, then the legal status of *sukuk* holders will be clear as being provided by the prospectus of issuance, given that they are owners of the assets and should not be affected by the state of bankruptcy. In other words, in case of bankruptcy, the assets owned by *sukuk* holders should not be included in the loss to be assessed and distributed among shareholders. In this regard, a distinction should be made between share and bond holders on the one hand and *sukuk* holders on the other hand as clearly indicated by the prospectus of issuance. By contrast, Interviewee 10 argued that the potential legal risks facing *sukuk* holders will be the controversy over their legal status in case SABIC company goes bankrupt or insolvent. It could be argued that whether *sukuk* holders will be considered by the CRSD and ACRSC as real owners or otherwise be treated as creditors. He also added that the law of bankruptcy in Saudi Arabia is very obvious regarding the treatment of shareholders and owners of securities including the traditional bonds. However, as yet the ambiguity associated with *sukuk* and the way *sukuk* holders should be dealt with, and as to whether *sukuk* holders will be able to prove themselves as true owners of their assets or that ownership is just nominal is still unclear.

Interviewee 11 made it clear that *sukuk* holders might face legal risks in the efforts to prove their rights as owners of the assets they have bought, as according to the financial reports made by SABIC company providing proof that the value of *sukuk* is

considered a debt on SABIC and as a result in case SABIC goes bankrupt or insolvent; *sukuk* holders will facing a legal dilemma as they will be considered as creditors similar to the holders of traditional bonds to claim back the money they have credited to the issuer account through the private company.

The following conclusion can be inferred from the analysis of the interviews provided in this section:

(i) Differences exist among the interviewees regarding the legal status of *sukuk* holders in case of bankruptcy or insolvency of the issuer, and whether the assets will be included in the loss as a result of bankruptcy so that bond holders and shareholders will have their share on those assets or otherwise the *sukuk* assets that have been sold to *sukuk* holders will be kept away from the assets owned by the company that will be distributed among shareholders and bond holders;

(ii) Given the fact that no cases of insolvency or bankruptcy has taken place in relation to *sukuk* in the Saudi market meaning that since no precedent has existed so far; that makes the legal status of *sukuk* holders unclear.

7.3.9 CONCLUSION

From the preceding analysis, the following conclusions are developed in terms of legal risks facing *sukuk* issuances in Saudi Arabia:

(i) '*Sukuk* term' has not featured in any special legislation issued by the CMA;

(ii) All the exits regulations and laws in Saudi capital market are related to stocks and debt instruments;

(iii) No difference is made between *sukuk* and bonds regarding the rules and regulations that have been issued by the CMA;

(iv) All companies that have issued *sukuk* including SABIC company have legally relied on the laws and regulations that regulate the issuance of shares and bonds;

(v) The CRSD and ACRSC are considered as a legal judiciary authority with regard to SABIC *sukuk* which are excluded from being under the authority of *Shari'ah* courts;

(vi) The *fatawa* issued by SBSS is non-binding and obligatory upon *Shari'ah* courts nor the CRSD and ACRSC;

(vii) The doubt of full independence of CRSD and ACRSC from CMA;

(viii) The existence of numerous legal bodies to investigate cases might lead to legal risks;

(ix) Differences in opinion exist among the interviewees with regard to the nature of the CRSD and ACRSC as being administrative with legal powers or being a judiciary panel;

(x) The validity of the CRSD and ACRSC in *Shari'ah* terms is questioned, as it does not include *Shari'ah* scholars or members (judges);

(xi) The CRSD and ACRSC are still excluded by the new Saudi judiciary system which will make their decisions less forcible;

(xii) The legal impacts of the different *fatawa* made by *Shari'ah* scholars in various matters in relation to SABIC *sukuk;*

(xiii) The *Shari'ah*-based differences among the members of CRSD and ACRSC as well as SBSS in *Shari'ah* terms is considered among the risks that threatens the legality of SABIC *sukuk* and the application of the relevant contract;

(xiv) The faulty and incomprehensive with regard to the information that must be available in the prospectus of issuance;

(xv) Failure to refer to the legal risks in the prospectus issuance of SABIC *sukuk*;

(xvi) The failure of CMA to focus and review the prospectus of issuance and all the legal relevant documents can lead to legal risks;

(xvii) The fake sale and the impossibility of transferring the assets from the issuer to *sukuk* holders as well as the inconsistency with the judiciary system and *Shari'ah* principles leads to legal risks;

(xviii) The uncertainty of the underlying assets in the prospectus of the issuance of SABIC *sukuk* which can be led to legal risks;

(xix) The uncertainty of the legal status of *sukuk* holders (owners – debtors);

(xx) The non-existence of a special law with regard to SPV;

(xxi) The failure of keeping the assets away from the issuer in favour of *sukuk* holders in case of bankruptcy or insolvency.

7.4 AN INTERPRETATIVE DISCUSSION

This section provides an interpretative discussion around the analysis of the interview responses from specialised individuals in the field of Islamic finance in general and *sukuk* in particular presented in the preceding sections in relation to the structure and prospectus of SABIC s*ukuk.* Thus, each section presents an analysis of each of the questions raised in the structured interviewing sessions. After presenting a brief analysis of the interview material through interpretative method, then an attempt is given to provide critical analysis with the objective of giving further meaning to the analysis.

7.4.1 The Law of *Sukuk* in the Saudi Financial Market

The Saudi financial market had officially start in the 1950s; however, the establishment of the basic systems of the market by the government was not until 1980s (Al-Muharrami, 2009). According to the Financial Market Regulations featuring the Royal Decree No. (M / 30) on 01/08/2003, the CMA was established as it is considered as a government authority which is independent in terms of administration and finance, and directly linked with the Prime Minister. In addition, the CMA is in charge of the control, development, and organisation of the financial market, as well as issuance of regulations and the appropriate rules and directives for the application of the financial market system aiming at creating the proper environment for market investment besides boosting the trust on the market by ensuring transparency for companies associated with the market, and protecting clients and investors in money exchange from potential malpractices in the market (CMA website).

It should be noted that in comparison to financial markets of other countries, it could be maintained that the CMA has been far lagging behind by opening a secondary market for *sukuk* in 2009 (Al Elsheikh and Tanega, 2011). Even though, the

establishment of a secondary market has been good news for financial expansion, financial inclusion, and all the relevant stakeholders including investors in *sukuk*, the general desire has been the exclusion of *riba*-based bonds from all market transactions, and accordingly the market has been given the name '*sukuk* and bonds market'.

The Saudi financial market has focused on introducing regulations and laws that organise the financial market, while they always addressed the securities in general by stopping short of differentiating between all the type of securities in terms of laws and regulations (Al Elsheikh and Tanega, 2011). Given that, according to Interviewee 9, every form of securities has its own legal nature and its basic structure in addition to the legal rights and bindings associated with every form of securities not to mention the legal implications associated with every transaction linked with any form of securities in case of failure to abide with the terms and conditions associated with appropriate form of securities no matter being bonds, *sukuk*, shares or others. That has been confirmed by the CMA's regulation for defining terminology featuring all regulations issued by the Royal Decree No. M/30 dated 01/08/2003 that the term securities should mean;

> (1)Shares; (2)Debt instruments; (3)Warrants; (4)Certificates; (5)Units; (6)Options; (7)Futures; (8)Contracts for differences; (9)Long term insurance contracts; and Any right to or interest in anything which is specified by any of the paragraphs (1) through (9) above .

From the above, it becomes obvious that *sukuk* could be classified as a debt instruments (No 2),while no reference to the term '*sukuk*' is made indicating that most likely no differentiation is being made between *sukuk* and other *riba*-based debt instruments. In the conduct of this study, the regulations regarding the promotion of securities has also been reviewed, therefore, it has become obvious that the regulations have always generally referred to the securities featuring all the laws and regulations and has not made any special reference to the term *sukuk*. This implies as if *sukuk* are being considered a sort of securities similar to *riba*-based bonds, and that all regulative and legal procedures applied to *riba*-based bonds could also be applied to *sukuk* including SABIC *sukuk* with no difference. This is a view which is supported by all those who have been interviewed indicating a major fault in the regulations regarding the promotion of securities in the Saudi financial market as it has failed to

differentiate between *sukuk* and other form of securities in terms of legal nature. In addition, it should be noted that what is being referred to as the 'rules of registration for securities in the Saudi market' has also been reviewed, whereby the rules have not included any special arrangements for *sukuk*, but instead those rules have mentioned the conditions for registration and listing of shares and debt instruments again indicating that *sukuk* are being treated similar to *riba*-based bonds featuring all procedures. Therefore, it could be argued that there is no obvious reason as to the failure to introduce laws and systems to be specially designed for *sukuk* as most of the interviewees have pointed out. The further substantiate to this, it should be noted that the CMA does not actually make a legal distinction between *sukuk* and bonds, which explains its failure to introduce laws specially designed for *sukuk*.

With regard to the law to be enforced, it should be mentioned that the prospectus of issuance of SABIC *sukuk* provides that; "SABIC *sukuk* should be subject to the prevailing laws and regulations in Saudi Arabia according to the jurisdiction of *Shari'ah* law as practiced in Saudi Arabia, and should be interpreted accordingly" (PISS, 2008). However, it could be argued that the prevailing laws and regulations in Saudi Arabia could constitute a major risk that might face SABIC *sukuk* as well as other *sukuk* that have been issued so far in Saudi Arabia. Having said that, the prevailing laws and regulations in the Saudi financial market that feature in the prospectus of issuance do not make a distinction between *sukuk* and bonds indicating that *sukuk* are being treated similar to *riba*-based bonds. That has been stressed by one of the interviewees by pointing out that the issuer of SABIC *sukuk* has taken into account the laws and regulations of securities that do not make a distinction between *sukuk* and bonds.

Moreover, it should be noted that the bond and *sukuk* market in Saudi Arabia has not witnessed so far any precedent of bankruptcy or insolvency featuring the companies involved in *sukuk* business, and that makes things more complicated as Interviewee 10 has pointed out. It has been argued that the legal nature of *sukuk* including SABIC *sukuk* as well as the legal status of *sukuk* holders, seem to be both unclear. That is for the simple reason that first; a special law for *sukuk* in Saudi Arabia is non-existent and taking into account the legal differences between Islamic contracts as all that would increase the legal risk potential. Secondly, the fact that *sukuk* market is still juvenile in

its early stages of development so that the number of issuances compared to other countries such as Malaysia is considered humble, and as it has already been mentioned that has made the Saudi market safer as it has not suffered so far from bankruptcy or insolvency featuring any of the companies involved in *sukuk* business. However, should that happen, it could be possible to identify the potential risks provided that a special law for *sukuk* exists. That line of thought is being supported by the following stipulation featuring the prospectus issuance of SABIC *sukuk* that;

> Prospective Holders should note that to the best of SABIC's knowledge, no securities of a similar nature to the *sukuk* have previously been the subject of adjudicatory interpretation or enforcement in Saudi Arabia. Accordingly, it is uncertain exactly how and to what extent the *sukuk*, the conditions and/or the *sukuk* documents would be enforced by a Saudi Arabian court or the Committee for the Resolution of Securities Disputes and the Appeal Panel (PISS, 2008).

Thus, it could be argued that the legal situation with regard to SABIC *sukuk* is vague and blurry due to the absence of a special law featuring *sukuk.* This view is also supported by Al Elsheikh and Tanega (2011) as well as all the interviewees.

Consequently, it could be maintained that the absence of Saudi special law for *sukuk* could be the first potential risk that SABIC *sukuk* might encounter as to settle disputes and conflicts that might take place between *sukuk* holders and SABIC company in case the latter suffers from insolvency or bankruptcy.

7.4.2 The Legal Body Entrusted with Cases of Disputes and Conflicts involving SABIC *Sukuk*

The SABIC *sukuk* prospectus stipulates that;

> The Committee for the Resolution of Securities Disputes and the Appeal Panel (the "Committee") shall have exclusive jurisdiction to hear and determine any suit, action or proceedings, and to settle any disputes, which may arise out of or in connection with the *sukuk* or the *sukuk* documents and, for such purposes, all relevant parties 'including the Issuer and the Holders' irrevocably submit to the jurisdiction of the Committee. No suit, action or proceedings which may arise out of or in connection with the *sukuk* or the *sukuk* documents may be filed or brought outside Saudi Arabia and no court or any judicial authority outside Saudi Arabia shall have jurisdiction to hear any such claim (PISS, 2008).

This point has been stressed by all interviewees that in the current situation in Saudi Arabia, the CRSD and ACRSC are considered the legal authorities to be entrusted

with the investigation of cases of disputes involving investors in securities within the jurisdiction of the financial market system and its executive regulations, as well as the regulations, rules and directives of the market authority with regard to the public and private rights, and that the CRSD and ACRSC are the body of judiciary power and authority to investigate cases of dispute and conflict involving *sukuk* including SABIC *sukuk*.

Having said that, the Saudi market regulations have stipulated the two panels in terms of formation, authority and limitation of power in accordance with the royal decree No. (M/30) dated 01-08-2003. However, as pointed out by interviewee 9 that since the Constitution of the Kingdom of Saudi Arabia that governs the country is inspired by *Shari'ah* principles, *Shari'ah* courts, by definition, should represent the body to be entrusted with the investigation and conflicts involving SABIC *sukuk* as those courts should be controlled by *Shari'ah*-trained judges and their decision should only be overruled by the power of *Shari'ah*. However, the fact that *Shari'ah* courts in Saudi Arabia need more organisation and specialisation such as the establishment of specialised commercial courts to be controlled by highly trained, highly qualified, and highly experienced judges on issues related to Islamic financing. It should be noted that as the analysis of the interviews in the preceding sections indicate, these issues were all raised by all the interviewees. It could, therefore, be argued that those institutions were established as to make up for any malfunction associated with *Shari'ah* courts as it has been mentioned by interviewee.

In contrast, in the CMA regulations there is a condition that the members of the CRSD and ACRSC should necessarily be legal experts as well as knowledgeable in jurisprudence of transactions or *fiqh al-mua'malat*. In this regard, it should be stated that all the members of the CRSD and ACRSC do not have *Shari'ah* background, as their education and experience are not related to the *fiqh al-mua'malat* according to their CVs. This could constitute a major risk for *sukuk* including SABIC *sukuk* in case of potential disputes, as the members of the panels may not be qualified to investigate such disputes as has been pointed out by Interviewee 10.

It is worth mentioning that as far as *Shari'ah* courts are concerned, judges most likely reject any case involving *riba*-based contract as invalid. That is exactly what has been referred by one of the judges who have been interviewed by probably giving his

reasons based on one of *Shari'ah* rules that states 'whatever is based on incorrect reasoning will be incorrect' meaning that *sukuk* that has been structured in a way inconsistent with *Shari'ah* should not be valid in *Shari'ah* terms. That line of thought is consistent with the idea from Interviewee 10 that the main aim behind the establishment of those institutions could be to investigate cases of dispute and conflicts featuring securities where in most cases *riba*-transaction cannot be ruled out. Thus, it could be argued that the absence of specialised commercial courts from matters involving such issues should be considered among the legal risks that SABIC *sukuk* has to cope with not to mention the lack of restrictions in relation to the nomination of the members of those panels that could be described as being linked with *Shari'ah* due to practicing the same role to be undertaken of the judges of *Shari'ah* courts.

7.4.3 The Legal Implication of Failure to Abide with the Decisions *Fatawa* Issued by *Shari'ah* Committees

In relation to the failure to abide with *fatawa* issued by the *Shari'ah* committees, the prospectus of issuance of SABIC *sukuk* stipulated that (PISS, 2008):

> Prospective holders should note that different *Shari'ah* advisers, and Saudi courts and judicial committees, may form different opinions on identical issues and therefore prospective holders may wish to consult their own legal and *Shari'ah* advisers to receive an opinion if they so desire. Prospective holders should also note that although the SABB *Amanah Shari'ah* supervisory committee has issued a pronouncement confirming that the *sukuk* as described in the detailed pronouncement are in compliance with *Shari'ah* principles, such a pronouncement would not bind a Saudi Arabian court or judicial committee, including in the context of any insolvency or bankruptcy proceedings relating to the Issuer, and any Saudi Arabian court or judicial committee will have the discretion to make its own determination about whether the *sukuk*, the *sukuk* documents and the related structure (or any part thereof) complies with Saudi law and *Shari'ah* principles and therefore is enforceable or otherwise. Accordingly, no person (including, without limitation, the Issuer) makes any representation that the *sukuk*, the conditions and any other *sukuk* documents comply with *Shari'ah* principles, except for the detailed pronouncement of the SABB *Amanah Shari'ah* supervisory committee.

From the forgoing, it is obvious that the decisions to be made by SBSS should neither be binding *Shari'ah* courts nor should it be binding the CRSD and ACRSC, as the prospectus of issuance of SABIC *sukuk* clearly indicates that the *fatwa* to be issued by the SBSS does not give any guarantee that SABIC *sukuk* would be consistent with the

laws and regulations that control the Saudi financial market in terms of structure and other documents.

Furthermore, the SBSS does not provide guarantee that such *fatwa* should be consistent with the ideas to be maintained by the CRSD and ACRSC in terms of *Shari'ah* principles. Consequently, the potential risk that SABIC *sukuk* has to cope with features in the failure of the members of the CRSD and ACRSC to recognise the *fatwa* that has approved SABIC *sukuk* and the subsequent legal implications. Such implications include the possibility of nullification of the contract rendering *sukuk* holders being incapable of proving their rights, which as a point has been confirmed by one of the interviewees. On the other hand, in order to make sure that guarantee is given to all parties particularly the holders of SABIC *sukuk*; it becomes necessary that the *fatawa* to be made by SBSS should be final and irreversible by presenting those *fatawa* to the appropriate committees of the CMA for approval before being presented to investors as it has been suggested by one of the interviewees. Alternatively, an independent body can be established for the approval of *fatawa* to be made by SBSS featuring banks and companies so that those *fatawa* become final after approval in case of being presented to any judiciary authority in the Kingdom. With that system, a legal guarantee will be given that those *fatawa* will not be overruled in case of insolvency or bankruptcy of SABIC company, so the *fatawa* made by *Shari'ah* boards become subject to being enforced.

Furthermore, from the section of the prospectus depicted above it is obvious that a possibility exists that the rules and conditions agreed upon between SABIC and *sukuk* holders might not observed due to the fact that no guarantee is given by a reliable body whose decisions are final and binding by confirming that *sukuk* structure is consistent with *Shari'ah* principles and the laws being introduced by the Saudi market. In other words, no independent body exist in legal and *Shari'ah* terms to approve *sukuk* structures and other financing contracts as being *Shari'ah* compliant as the case with central bank in Malaysia for instance. However, this made the SABIC company to identify in the prospectus of issuance that the company will not be responsible for SABIC *sukuk* structure whether the structure is *Shari'ah* compliant or not, and therefore, the associated prospectus of issuance with its contents of rules and

conditions is not being guaranteed recognised in *Shari'ah* and legal terms by the CRSD and ACRSC.

For this reason, among the legal risks that might encounter SABIC *sukuk* could be that the conditions and decisions made by *Shari'ah* courts and other legal panels could not be subject to execution. This is due to the fact that *Shari'ah*-based structured SABIC *sukuk* could not be binding to the CRSD and ACRSC in case of dispute or conflict involving securities between the issuer and *sukuk* holders. In other words, the differences in opinion in *Shari'ah* terms between SBSS and the members of the CRSD and ACRSC might lead to invalidation of *sukuk* in legal terms and the subsequent failure to enforce its provisions.

Consequently, it could be argued that among the risks that might face SABIC *sukuk* and other forms of securities as Interviewee 9 and 10 pointed out is being unaware of the approved opinion in *Shari'ah* terms regarding the financial transactions as being maintained by the CRSD and ACRSC. Since well-known *fiqh*-related old differences exist among *Shari'ah* scholars in many issues associated with financial transactions, SBSS might rely on a specific *fiqh*-related opinion as basis for *sukuk* structure, and that opinion might offend the approved opinion as to be practiced by the CRSD and ACRSC which tends to make a significant impact on the *sukuk* both legally and in *Shari'ah* terms. In other words, the *sukuk* might be satisfying the conditions in legal terms provided by the regulations to be issued by the CMA. However, in *Shari'ah* terms the *sukuk* might be inconsistent with *Shari'ah* principles and this is where *Shari'ah* and the law become at loggerhead. For that reason, some of those who have been interviewed suggested that recognisable *Shari'ah*-based standards such as AAOIFI standards should be adapted. However, those standards become binding to *Shari'ah* boards to be entrusted with the task of *sukuk* structuring as well as the bodies to be entrusted with investigating and decision-making on matter associated with *sukuk*. Consequently, the risk of the differences of the school of thoughts among the members of the CRSD and ACRSC, on the one hand, and *Shari'ah* boards, on the other hand, can be eliminated, as with the AAOIFI standards being adapted, there is only one reference which gives guarantee that the *sukuk* will not be invalidated in *Shari'ah* terms by the CRSD and ACRSC. Thus, should it not have been for such organisation and the existence of binding standards, the potential legal risks might be

faced by SABIC *sukuk* holders include organizational and *Shari'ah*-related inconsistencies featuring the structure of the *sukuk* they hold as well as the prospectus of issuance and the documents to be attached to it, which might legally render *sukuk* holders incapable of proving their rights in case of insolvency or bankruptcy of the issuer company.

7.4.4 The Legal Nature of the CRSD and ACRSC and the Degree of Its Independence

The legal nature of the CRSD and ACRSC that have been stipulated by the financial market regulation in terms of formation and authority provided by the Royal Decree No. M/30 dated 01/08/2003, remains among the controversial issues as well as the degree of independence of those panels have also been controversial. However, Article 25 of the CMA stipulates that;

> A panel under the name 'the Committee of the Resolution of Securities Disputes (CRSD)' will be established by the Saudi market authority (SAM), and that panel will be entrusted with the investigation of disputes that take place within the jurisdiction of that system and its executive regulations as well as the regulations of the authority and the market, their rules and directives with regard to the public and private rights. The panel preserves all the necessary authorities for investigating and making decision on the cases to be presented to them, including the authority to call witnesses, making decisions, imposing punishments, and ordering the presentation of evidence, documents …*etc*. The members of the panel will be appointed following a decision to be made by the council i.e. the CMA council, for three years subject to renewal.

It should be mentioned that Interviewee 9 and 10 pointed out that the market system has secured for those panels the right of jurisdiction and decision-making regarding cases of disputes and conflict involving securities including SABIC *sukuk*. In addition, it has given those two panels the full independence to practice their activities as a judiciary body in relation to cases of disputes involving securities with the due neutrality and honesty, therefore that no one regardless his status should have influence or control of the cases to be investigated by those panels. Moreover, the two relevant panels also should not be subject to the influence of the CMA, and the fact that in many cases its decision has not been in favour of the CMA testifies to that.

It could be argued that to a great extent the full independence of CRSD and ACRSC to practice their activities as a judiciary body will provide a great certainty and guarantee to the investors in *sukuk* in general and SABIC *sukuk* holder in particular.

Nonetheless, that view point has not been taken for guaranteed by Interviewee 11 due to some benchmarks that those two panels might deviate from the principle of neutrality in cases against companies and other clients featuring securities such as *sukuk*, for instance in favour of the CMA given that the members of the CRSD and ACRSC are being appointed by the CMA not to mention the fact that they are being paid by the CMA. Moreover, the headquarters of the two panels is located within the building of the CMA which raises doubts making investors in SABIC *sukuk* less reassured of the possibility of those panels to take sides in their decision favouring the CMA in case the latter becomes involved in a case against SABIC *sukuk* for instance, and is considered among the legal risks SABIC *sukuk* has to cope with.

It is noteworthy that the principle of the judiciary independence in Saudi Arabia, which is considered among the well-established principles in Islamic *Shari'ah*, is also ensured by the Constitution of Saudi Arabia in Paragraph 1 of Article 46 under the Title 2 that "Judges are independent and, in the administration of justice, they shall be subject to no authority other than the provisions of *Shari'ah* and laws in force. No one may interfere with the Judiciary".

Thus, the independence of the judiciary authority does mean its independence from the government as well the parliament (the legislative authority) so that the two authorities should not have control over the judiciary activities in any way.

However, the issue of exception of certain powers of the public and administrative courts to be given to administrative panels (CRSD and ACRSC) to be controlled by ordinary government staff rather than professional judges to make decision on specific cases of disputes with the power of judiciary courts remains a controversial matter in relation to principle of independence of the judiciary. This also runs against the independence principle ensured by the Saudi constitution which is shaped by *Shari'ah*. According to Interviewee 11, the inconsistency is that the members of the CRSD and ACRSC are not professional judges to be entrusted with making decision on matters involving disputes and imposing punishment on the offending side. Moreover, the formation of the CRSD is considered among the inconsistencies, and to be more precise, the inconsistency of Article 25 of the CMA system with the Constitution stipulating that: "The members of the panel will be appointed in accordance with the decision of the council i.e. the council of the financial market

authority, for three years subject to renewal". In reflecting on this, Interviewee 11 argued that the inconsistency with the Constitution is due to the members of the CRSD are being appointed according to a decision made by the council of the CMA, and that will eventually constitute a risk to clients of SABIC *sukuk*. It is, hence, inconceivable that the CMA becomes in one hand part of the case as against SABIC Company, and in the meantime becomes a judge who investigates the case, which, hence, represents a conflict of interests and lack of independence. This cast doubts that the decision to be made by the panel might favour the CMA, as it has appointed the members of the panel.

It should be noted that among the legal risks that might be exposed to the investors on SABIC *sukuk* and other types of securities which have to cope with is that numerous bodies in Saudi Arabia exist to investigate cases of dispute including the public judiciary, the administrative judiciary, and also the panels (the administrative authorities) of judiciary nature. According to Interviewee 11 that could lead to problems and legal risks including failure to enforce decisions as well inconsistency of opinion in *Shari'ah* terms. However, these problems have not been clearly defined due to the fact that no case involving bankruptcy or insolvency relating to Saudi market has been reported to be investigated by the two panels so far nor there are any cases under investigation to the CRSD and ACRSC with regard to *sukuk*. This makes it difficult to predict the potential legal risks that might encounter SABIC *sukuk* so that they can be avoided as has been stipulated by the prospectus of issuance.

Finally, given that the system of the judiciary have excluded the CRSD and ACRSC from the umbrella of the public and administrative judiciary in terms of their executive methods, it is necessary the exemption should not be extended to include the exemption of that panel from the principle of independence of the judiciary through the sustaining intervention of the council of the CMA (the executive body) regarding the appointment of the members of the panel (the judiciary body). As the principle of the judiciary independence is a constitutional matter that must be observed as it has been pointed out throw the interviews section.

7.4.5 The Binding and Enforceable Nature of the Decisions of the CRSD and ACRSC

After the examination and evaluation of the Constitution of the Saudi Arabian Market Authority (SAMA), it becomes obvious that the system has been keen to establish the CRSD as to become capable of undertaking its duties regarding disputes featuring securities. In this regard, the SAM stipulated by Article 25, Paragraph A, that it has been given the CRSD through CMA all the necessary powers for investigating and decision-making with regard to the cases involving calling witnesses, making decisions, imposing punishments, and ordering the presentation of evidence and documents. The CRSD also preserves the right to make decision to pay compensation as to order the condition to be restored as before. Alternatively, the CRSD can make the appropriate decision to preserve the right of the party that suffers from the damage. However, the CMA system in order to preserve the right of the disputing parties has established another panel, namely ACRSC, giving extra guarantee for preserving the rights of the parties involved insecurities related disputes, including SABIC *sukuk*, in obtaining rights such as the right to go to court at two stages so that any of the parties can go to the appeal panel ACRSC (second stage) should he have not been satisfied with the decision made by CRSD (the first stage). Article 25 Paragraphs Z and Y stipulates the formation of the ACRSC panel entrusted with the investigation of appeal applications against the decisions to be made by the CRSD to be presented within 30 days from date the decision have been made by the CRSD.

Having said that, the powers of ACRSC are defined by Article 25, Paragraph Z of the financial market regulation regarding the handling of the appeal applications against the decisions to be made by the CRSD as follows:

(a) Refuse to review CRSD decisions;

(b) Affirm CRSD decisions;

(c) Undertake *a de novo* review of the complaint or suit based on the record at the hearing before CRSD and to issue the appropriate decision.

(d) Nature of Decisions: The decisions of ACRSC are considered final and cannot be appealed.

On the other hand, the objection made by some of the interviewees regarding offering the CMA the right of making the decisions normally to be made by the CRSD and ACRSC ‘enforceable and binding’ in legal and *Shari’ah* terms, as this tends to make

this panel a jurisdiction panel. This implies that its decisions should be binding as to investigate cases involving disputes between two parties, in which case according to the financial market regulation those two panels would have been the same as the law and *Shari'ah* courts in nature. However, since according to the Constitution the judiciary in Saudi Arabia has to be based on *Shari'ah*, this panel could be described as invalid in *Shari'ah* terms as its members are not *Shari'ah*-trained judges, but rather have experience in law. The invalidity of the panel can be argued on ground that panel might also make its decisions based on sources other than *Shari'ah*.

In addition, it could be argued that the duty of the CRSD and ACRSC should be to settle the differences between the two disputing parties so that in case of failure to reach a compromise the case should be referred to the appropriate court for making the final decision. In other words, the panel has to reach a compromise to the satisfaction of the two parties, or otherwise the case has to be referred to the relevant *Shari'ah* court.

7.4.6 Determining the Body to Investigate Cases Involving Securities Disputes including SABIC *Sukuk* under the New Judiciary Arrangement in Saudi Market

In 1426 H, a Royal Decree has been issued regarding the organisation of the judiciary systems and sorting out disputes in Saudi courts. The executive methods of the judiciary and the Grievance Board system was also issued in 1428 H with the inherent recommendation for the formation of more than 70 panel or authority to reviewing all panels of judiciary nature. Each of these panels would be expected to rely on special regulations regarding their powers and jurisdiction in accordance with a Royal Decree to sort out disputes originating from the application of those rules, as an exemption of the duties of the public and administrative courts. Article 9 of the new judiciary system stipulates the rearrangement and reorganisaton of the courts as to be classified into five types, according to which the commercial courts are classified as specialised courts.

It should be noted that a great hope and ambition of those concerned with *sukuk* whether in legal terms or *Shari'ah* terms is the establishment of specialised courts under the label of commercial courts to include all the semi-judiciary panels. In addition, it is expected that investigative cases of disputes between investors of *sukuk*

should be entrusted with those panels instead of the judiciary or semi-judiciary panels or administrative panels, which should identify the legal identity of those panels as it has been suggested by one of interviewee 11. However, following the approval of those commercial courts featuring the new judiciary organisation, many of those panels including the CRSD and ACRSC, which are the two panels entrusted with cases involving SABIC *sukuk*, are still exempted in terms of their duties from the public and administrative judiciary, a matter that makes the courts in Saudi Arabia still multiple and complex which tends to render the decision to be made by those panels less powerful.

In this regard, it has been suggested that the two panels have to be affiliated to the specialised commercial courts following the example of the semi-judiciary commercial panels that have been affiliated to the umbrella of public and administrative courts. Such an affiliation, however, will secure the enforceability of the decisions to be made by those semi-judiciary panels, and tends to make those panels to look more judiciary in nature. It should be noted that the isolation of those panels from the specialised courts offends the unity of the judiciary, and it is preferable that the judiciary should be affiliated to the same body namely the Ministry of Justice without being disputed by the Ministry of Commerce or the CMA as the situation currently stands.

Furthermore, the isolation of those panels from the judiciary would be considered as one of the most significant risks facing SABIC *sukuk*, which can be a reason behind poor execution of the decisions made by those panels. This is because of the fact that some people perceive those panels as not being judiciary bodies but rather administrative bodies whose decisions have no binding power, on the one hand; and the diversification of the decisions to be made by those panels tends to make them less powerful and might delay the execution process, on the other hand. Again, as it has been asserted by Al Elsheikh and Tanega (2011) that the lack of clarity of the enforceability of any law or any decision of a judicial authority could be one of the legal risks that should be avoided.

7.4.7 The Legal Implications of Potential Jurisprudential Differences between the Members of the CRSD, ACRSC and SBSS

As discussed previously, the prospectus of issuance is considered among the most important documents and papers that need more legal attention whether by CMA, which represents the organising body that controls the issuance and circulation of securities including SABIC *sukuk*, or by the issuer and *sukuk* holders who represent the parties of the contracting relationship. However, one of the interviewees made it clear that failure to pay the due attention to prospectus of issuance in legal terms tends to lead to risks as well as problems in *Shari'ah* and legal terms including the possible nullification of *sukuk* and the subsequent loss of the rights and the potential dispute and conflict between the issuer and *sukuk* holders.

For that reason, it could be argued that the prospectus of issuance has to feature an accurate description of the contracting relationship between the relevant parties by mentioning the name of the *Shari'ah*-based contract indicating the contracting relationship between the issuer and *sukuk* holders, as well as an accurate description of all the rights and duties of every party as it has been suggested by AAOIFI (2010). However, after examining and analyzing the prospectus of issuance of SABIC *sukuk* in legal terms, it has become obvious that the contracting relationship between the issuer (SABIC Company), and *sukuk* holders has not been clear to the point of clarifying the legal relationship that has taken place between the two parties as the prospectus of issuance stipulates that;

> SABIC Company issues *sukuk* each of which represents a common part of *sukuk* assets to be presented to investors. From their part the investors and those interested in buying will fill an application for underwriting according to which they give their consent for Saudi Arabia HSBC Bank Company Ltd (SABB) to become their representative and appointing SABIC Company as a trustee of *sukuk* assets on their behalf. They also have to determine on the application the number of *sukuk* they wish to purchase. After the completion of the applications SABIC Company has to transfer *sukuk* assets to the trustee of *sukuk* assets and issues *sukuk* to investors, and hence the representative of *sukuk* holders will issue an order for transferring the value of *sukuk* to SABIC Company (PISS, 2008).

From the above, it could be concluded that, as far as the prospectus of issuance is concerned, things are being generalised rather than being explained in detail. That generalisation includes the name of the contract on which SABIC *sukuk* has been

structured as well as the definition of the parties that will continue in the contracting relationship until SABIC *sukuk* expires. That makes the reader of the prospectus of issuance perhaps become confused, which is due to the fact that SABIC as seller has set a condition that it stays as a marketer for *sukuk*, and that questions the real legal status of SABIC company, and whether it has sold or hired *sukuk* or otherwise whether another relationship exists. As can be seen, the observed vagueness in relationship has disclosed a varying disagreement between the members of SBSS as has already been explained.

In addition, among the legal comments that have been made regarding the prospectus of issuance, and comments have also been made by some of the interviewees is that the prospectus of issuance has failed to define clearly the assets to be sold by the issuer to *sukuk* holders. It is worth mentioning that by reviewing the balance sheet of SABIC company, the assets that had been sold to *sukuk* holders did not exist in the company records; and also no legal evidence existed that would make one believe that those assets had been assessed and could be sold and transferred from the issuer to *sukuk* holders.

Moreover, the prospectus of issuance failed to identify the method of the assessment of the underlying SABIC *sukuk* and the mechanism through which those assets will be sold and transferred to *sukuk* holders, as whether that mechanism satisfies all conditions in *Shari'ah* and legal terms in accordance with the provisions relating to the judiciary systems in Saudi Arabia in relation to legal documentation by transferring *sukuk* from the issuer balance sheet to the records of the *sukuk* holders.

It should be noted that there have been differences among the members of SBSS with regard to the assets of SABIC *sukuk* as has already been explained. Such differences are also emerged in relation to whether the underlying of SABIC *sukuk* assets considered as marketing contract or privilege rights or otherwise the assets represent the rights of marketing the products that have been hired by *sukuk* holders given that the prospectus of issuance has provided that the assets that will be transferred sums of money that will be collected following the marketing of products of the SABIC subsidiary companies. Nonetheless, it should be noticed that what has been presented to the *Shari'ah* board represents a summary of the prospectus of issuance in which no

mention is made to the fact that the assets will be in the form of sums of money according to one of the SBSS.

Hence, it could be stated that the summary of the prospectus of issuance that has been approved by SBSS is vague and incomprehensive, while the details depicted in the original prospectus, as one of the members of the SBSS described, as being long and written in the English language which makes it futile and needless to be reviewed.

In reflecting on these comments, he legal comments that have been raised above have to be included in the prospectus of issuance as well as the summary of the prospectus of issuance which should clearly explain the name of the contract that clarifies the relationship between the issuer and *sukuk* holders in legal terms as well as in *Shari'ah* term. In addition, the nature of the assets to be sold to investors and the method used for the assessment of those assets should be calcified in the issuance of SABIC *sukuk*. Moreover, the two prospectuses must include all potential *Shari'ah*-related and legal risks that might encounter *sukuk* and the possible ways of dealing with those risks or minimising the damage, which to a great extent is non-existent in SABIC *sukuk*. In addition, the documents and papers in relation to SABIC *sukuk* should be accessible to everyone and that any information or documents related to *sukuk* should not be held back from *sukuk* holders which they are going to buy. That will be among the simplest legal rights given by the system to *sukuk* holders or otherwise it becomes doubtful that some sort of ignorance exists that makes *sukuk* holders eligible to claim compensation for any potential damage that might have been caused due to poor information or the difficulty to acquire that information.

It becomes clear by reviewing the prospectus of SABIC *sukuk* that the *sukuk* holders do not preserve the right to have access to all documents in relation to SABIC *sukuk* that they are going to subscribe. In addition, *sukuk* holders have signed an agreement that they have no right to access some of the documents and papers or order a copy of them which is legally wrong according to the provisions of AAOIFI standards as it has been stated.

Among the legal risks that might encounter SABIC *sukuk* is that the CMA most likely considers the organisation of all documents and papers and the extent to which those documents are being consistent to laws and regulations of the CMA irrespective of its

validity in *Shari'ah* terms. For that reason, the regulations of the CMA have stopped short of providing for the existence of *Shari'ah*-trained consultants for companies that issue *sukuk* as a condition, while it stipulates the existence of legal consultants. This could result in *sukuk* and the associated documents to be valid in terms of organisation but subject to risks as well as problems in *Shari'ah* terms that could expose *sukuk* to some sort of legal risks such as being unenforceable. As a consequent, *sukuk* and the associated documents has to be considered both legally and in *Shari'ah* terms to prevent any potential legal and *Shari'ah* risks.

7.4.8 *Sukuk* Holders

There is no doubt that *sukuk* holders are considered the most vulnerable of the parties with regard to the potential legal risks in *sukuk*, as the legal invalidation of *sukuk* structure will subsequently result in the loss of their rights and probably the assets they own as it has been noted by all the Interviewees. For that reason, *sukuk* holders have a duty to make sure that their legal rights are well preserved and guaranteed with regard to the ownership of the assets that have been bought and they have been actually transferred from the records of the issuer to the records of *sukuk* holders.

Among the legal risks that might potentially encounter *sukuk* holders include the vagueness associated with their legal status in relation to the CRSD and ACRSC. The question is as to whether *sukuk* holders will be considered real owners of the assets they have bought from SABIC *sukuk* company so that they become legally capable of proving their rights of ownership of the assets to prevent them from being counted among the assets of bankruptcy to be shared by shareholders and creditors in case the issuer goes bankrupt. As otherwise, their relationship with the issuer will be that between a creditor and a borrower, which is similar to that between the issuer of the traditional bond and the holder of the bond. That vagueness can be due to the fact that the legal status of *sukuk* holders is not clear for many reasons. For example, a special law featuring *sukuk* is non-existent in Saudi Arabia as has already been mentioned, which is essential to make a distinction between *sukuk* holders and bond holders implying that all investors will have the same legal status with respect to securities. However, the financial market system has so far failed to make a clear distinction between *sukuk* and bonds by considering both of them as a type of securities of the same system. In addition, no precedents exist with regard to cases or incidents that

have been investigated by the CRSD and ACRSC as to use the decision made by those panels as a guide to decide whether *sukuk* holders should be treated as real owners of the assets which they have bought or creditors such as the case with bond holders.

On the other hand, it has been pointed out that most investors in *sukuk* in the Saudi market belong to major companies, and those companies employ a number of law specialists as to secure the legal rights of those investors in relation to proving their rights, and that their purchase of *sukuk* is a clear indication that they are somewhat reassured to invest in such type of securities. However, that reassurance might have been due to the fact that they are sure that their capital as well as their potential return has been guaranteed.

According to one of the interviewee he pointed out that it is clear that *sukuk* holders might encounter legal barriers with regard to proving their right as real owners of the assets that they have bought due to the fact that the financial reports issued by SABIC Company provide evidence that the value of *sukuk* is to be owed by SABIC as a debt, so that in case of insolvency or bankruptcy, SABIC *sukuk* holders will face a legal barrier. As in such a case they will be considered as creditors in which case they will be among the holders of traditional bonds with the same legal status with regard to claiming back the sums they have paid into the issuer's account through the private company. Nonetheless, it can be argued that this situation does not prevent a clear legal status to become available for *sukuk* holders not to mention the fact that the risk potential still exists given that the issuer might lose everything in which case any guarantees given by the issuer featuring the capital and returns for those companies might not be worthwhile. Consequently, the clarity of the legal status of *sukuk* holders for real ownership of the assets representing *sukuk* must be ensured, which should make sure of the transfer of those assets to investors in legal terms.

7.4.9 SPV

The main purpose of the SPV is to keep the assets to be sold by the issuer to *sukuk* holders in a special legal entity fully independent from the issuer to maintain the rights of *sukuk* holders away from the issuer as it has been noted by one of the interviewee. In addition, the system involving the establishment of commercial company in Saudi Arabia is full of complexities and challenges that could be money

as well as time consuming for the issuer. This makes the *sukuk* cost-prohibitive as compared to traditional bonds that do not need the services of those companies with special purpose.

In this respect, according to Fitch Ratings the main factor that is likely to slow down or limit the growth of *sukuk* market is the high initial costs of issuing *sukuk* compared with other types of debt instruments (aleqtisadiah, 2014). It is worth mentioning that the issuing of *sukuk* is more expensive than bonds perhaps due to the complicity of the *sukuk* structures as well as the need of the structure to be approved by a *Shari'ah* committee which is costly. Additionally, the establishment of the SPV will cost more, as it is treated as private company when it comes to the establishment according to CML. It should be also mentioned that the establishment of SPV in countries other than Saudi Arabia is almost free of charge compared to the cost under the CML as there is no law and system for trust companies (SPV) in the CMA. Consequently, the companies that seek finance will be in favour of traditional bonds rather than *sukuk* due to the low cost of issuance (Jobst *et al.,* 2008). Investors also in securities will go for traditional bonds rather than *sukuk* for their potential returns due to the low cost of issuance so that tends to offer good returns to match the low costs of issuance.

As the analyses of the interviews indicate, there is an agreement among interviewees that not having a law for *sukuk* in the Saudi financial market has made it difficult to achieve the aim for which the special purpose companies have been established, which is to keep the assets of SABIC *sukuk* to be sold by the SABIC to *sukuk* holders in a SPV. In other words, the SPV in SABIC *sukuk* issuance is considered part of the issuer's properties (SABIC company) and it carries the same name as the issuer company, which indicates that the transfer of assets from the issuer to SPV might have been nominal and unreal a matter that renders *sukuk* holders incapable of proving the assets they have bought in legal terms.

It could, therefore, be argued that it becomes necessary to invent a special system for companies with special purpose different from the system involving commercial companies in the Saudi system that features many complexities and challenges that might be costive for the issuer in terms of money and time, and that point has been stressed by all interviewees.

7.4.10 SABIC *Sukuk* Assets and the Possibility of Bankruptcy

The most important difference between conventional bonds and Islamic *sukuk* is that the latter is normally linked with assets (Usmani, 2007). Therefore, Interviewee 6 (the first member of SBSS) has mentioned that SABIC *sukuk* have no tangible assets to be referred to by *sukuk* holders in case of bankruptcy of the issuer, but rather represent marketing contracts, usufructs or rights. However, the prospectus of SABIC *sukuk* deals with the issue of bankruptcy of the issuer as well as the legal rights of *sukuk* holders. While two of the members of the SBSS in the interview mentioned the right of *sukuk* holders to appoint another marketer in case SABIC goes bankrupt, they differ in their opinion with regard to disposal of *sukuk* assets and whether it would be possible legally to transfer the rights and benefits from the issuer to *sukuk* holders.

It should be stated that after the examination of the prospectus of SABIC with regard to the underlying assets of SABIC *sukuk*, it could be concluded that;

(i) It has become obvious that as regards to the assets of SABIC *sukuk* whether being rights, usufructs or marketing contracts, there are differences among the SBSS members regarding the nature of those assets, as the assets cannot be referred to in case of bankruptcy of SABIC, because they do not represent material assets to be transferred, owned or even separated legally from SABIC. This is due to the fact that they lack real separate value, but rather is valued in relation to SABIC. Having said that, however, in case SABIC goes bankrupt, the contracts will be invalid as they are linked to SABIC and its subsidiary companies. In another words, the usufructs and rights based on the marketing contracts between SABIC and its subsidiary companies will be financially worthless. Even if it was financially valuable and could be separated and owned by *sukuk* holders, SABIC would then have no right of selling it or otherwise relinquishing it to other parties as it has been stated in the prospectus. In addition, according to the SABIC *sukuk* prospectus, it has been noted that SABIC has set a condition that *sukuk* holders have no right of obtaining or otherwise of transferring or selling the assets even though they belong to *sukuk* holders.

Furthermore, it should be mentioned that SABIC has obtained the majority of the shares in those companies which seems that SABIC has managed to create those

contracts in order to produce assets, through which it can issue *sukuk* to help generate funding as it has been mentioned by one of the interviewee.

(ii) In fact, the issuance prospectus has discussed the issue of bankruptcy of the issuer through giving the right to *sukuk* holders to claim back their capital from the issuer. However, as has already been mentioned, the prospectus of issuance has stopped short of suggesting the method to be used by *sukuk* holders to claim the assets they own and how they dispose of those assets in a market such as Saudi market authority CMA where there is no proper law for *sukuk*. However, with regard to what has been mentioned by one of the members of SBSS that in case of bankruptcy of the issuer *sukuk* holders preserve the right of appointing another marketer; that argument disagrees with what has been stipulated by the prospectus of issuance that; "SABIC company has been appointed as the manager of assets to provide the marketing services and that decision will be irreversible" (PISS, 2008). Accordingly, *sukuk* holders cannot, under any circumstances, overrule that decision and that even in case of failure of SABIC to continue the job due to bankruptcy; the marketing contracts will neither be transferred to another marketer nor will they be disposed of by *sukuk* holders as has been provided by the prospectus of issuance.

7.5 CONCLUSION

After the discussion in the preceding section, it can be said that SABIC *sukuk* have been exposed to many deferent types of legal risks, which can be summarised as follows:

(i) There is no a special law and legislations for *sukuk* in Saudi capital market;

(ii) All the parties involved in SABIC *sukuk* have to consider all laws and legislations related to the stock and debt instruments;

(iii) CMA has failed to refer to the term '*sukuk*' in all his laws and legislations which means that SABIC *sukuk* and other *sukuk* are similar to conventional bonds in the measurement of the Saudi capital market;

(iv) SABIC company has legally relied during issuing its *sukuk* on the laws and regulations that regulate the issuance of shares and bonds;

(v) All the parties involved in SABIC *sukuk* have to deal with the CRSD and ACRSC which are not under the authority of *Shari'ah* courts;

(vi) The *fatwa* issued by SBSS is non-binding and obligatory upon *Shari'ah* courts nor the CRSD and ACRSC;

(vii) The full independence of CRSD and ACRSC from CMA is still questionable and unclear;

(viii) The existence of numerous legal bodies to investigate SABIC *sukuk* in the case of any dispute;

(ix) The uncertainty and the lack of transparency in the nature of the CRSD and ACRSC as being administrative with legal powers or being a judiciary panel;

(x) The validity of the CRSD and ACRSC in *Shari'ah* terms as it does not include *Shari'ah* scholars or members (judges);

(ix) The legal impacts of the different *fatawa* made by SBSS in relation to SABIC *sukuk* whether *SABIC sukuk* structure is consistent with *Shari'ah* or not;

(xii) The faulty and incomprehensive information that must be provided in the prospectus SABIC *sukuk;*

(xiii) The issuance of the prospectus of SABIC *sukuk* has failed to refer to the legal risks that SABIC *sukuk* might be exposed to;

(xiv) There is no real sale has been take place with SABIC *sukuk*;

(xv) The uncertainty of the underlying assets of SABIC *sukuk;*

(xvi) The uncertainty of the legal status of SABIC *sukuk* holders in the case of and dispute (owners-debtors);

(xvii) There is no special law with regard to SPV in the Saudi capital market as the SPV considered under the Saudi commercial law;

(xviii) The SPV is considered as one of the SABIC company subsidiaries which means that the assets of SABIC *sukuk* are still under the authority of SABIC Company, namely the issuer.

Chapter 8

CONCLUSIONS AND RECOMMENDATIONS

8.1 INTRODUCTION

In responding to the research questions identified in Chapter 1, this research studied the prospectus of issuance of SABIC *sukuk* and the attached supplementary documents carefully from *Shari'ah* and legal perspective. In addition, it also reviewed and discussed all the answers to the interviews that were rendered by the interviewees as the members of *Shari'ah* board as approving body of compliancy, lawyers, *Shari'ah* judges, academic staff or people who are involved in the CRSD and the ACRSC, which are the legal authority to investigate and solve any cases in *sukuk* in Saudi market. In addition, the AAOIFI's recommendations related to *sukuk* issued in 2008 and the stipulations of AAOIFI standards for *sukuk* in 2010 were considered in evaluating the SABIC *sukuk* for *shari'ah*, legal and SSB originated risks. In addition, the important decisions issued by the Islamic *Fiqh* Academy were also considered. By critically analysing and comparing all the above mentioned primary data, the structure of SABIC *sukuk*, and the terms and conditions provided by the SABIC *sukuk* prospectus, this study concluded that SABIC *sukuk* have been exposed to a considerable *Shari'ah* and legal risks. These are briefly discussed below.

8.2 ANALYTICAL REFLECTIONS ON THE RISKS ASSOCIATED WITH SBSS

One of the major findings of this study is the failure of SBSS to undertake their duties, as it is expected that SBSS have to play an active role in relation to the protection of SABIC *sukuk* against any sorts of risks in terms of *Shari'ah* and legal frames so that the *sukuk* can be considered consistent with *Shari'ah* principals. It can be argued, according to the findings established in the previous chapters, that SBSS have fell short of their expected role, duties and responsibilities according to the AAOIFI standards as well as the decisions issued by the Islamic *Fiqh* Academy. This should be considered as a major concern.

The second issue that emerged from the findings is that AAOIFI standards as well as the Islamic *Fiqh* Academy's Decision No 177(3/19) state that the SSB has to consist

of three members, and yet from the interviews featuring a number of specialists it become clear that three members might not be enough to approve any product as to be consistent with *Shari'ah* principals especially with regard to a new product such as *sukuk*. Therefore, it is considered as a source of risk as the voting is based on the majority so that the product will be become consistent with *Shari'ah* principals if two of the three members are in favour of the product. Moreover, the two members are considered inadequate not to mention the fact that *sukuk* should be subject to detailed evaluation and investigation to avoid criticism as has been explained by most of the interviewees. Consequently, the inadequacy of the number of SBSS is considered among the risks that have to be paid attention to in further issuances.

The findings presented in the earlier chapters also indicate that the lack of diversity among the SBSS in terms of specialisation, while the nature of *sukuk* indicates that different specialisation among SSB is highly needed as indicated by interviewees so that the approval of any *sukuk* structure should be based on a comprehensive view in terms of *Shari'ah*, legal and financial aspect so that any judgment (*fatwa*) to be made should be consistent in terms of *Shari'ah* as well as the legal aspect in order to avoid difficulties in the application of such transfer of assets as it has been suggested by the Islamic *Fiqh* Academy's Decision no 188(3/20). Having said that, as the findings indicate SABIC *sukuk* structure has been approved by three members who are mainly specialised in *Shari'ah* and yet it seems no one of the members has any experience in structure of the conventional products such as the legal and accounting experts. This is considered a potential risk area in terms of efficiency in structuring but also in terms of ensuring every aspect of *sukuk* being fully covered through *Shari'ah* and other requirements.

Similar to some other studies, this research also found that the members of SBSS seem to be busy with many occupations and they do not have enough time to focus on the structure in front of them. Therefore, some of the risks to which SABIC *sukuk* might be exposed is the fact that the members who approved the structure of SABIC *sukuk* do not have enough time to closely and carefully study and examine the *sukuk* structure, as the members have been busy with memberships of other boards not to mention their own private businesses and other occupations. As a result, they may have made their judgment of approving SABIC *sukuk* without paying satisfactory

attention to the setbacks in *Shari'ah* terms as has already been pointed out in the discussion in the previous chapters. For that reason, many of those who have been interviewed have suggested that members of the boards should have the maximum time allowed to take part in the study of the structure before the final approval as well as the involvement in other committees should be limited.

The findings in this study also shown the dependence of the SBSS upon the banks they are working with as a source of SBSS related risk. However, the member of SSBs should be fully independent to avoid any conflict of interest between them and the bank or corporations that have issued the *sukuk*. As the findings in this study shows that the members of SBSS are dependent on the SAAB bank as they work for it as a *Shari'ah* consultant which might lead to certain risks as it has been indicated by AAOIFI, Islamic *Fiqh* Academy as well as some of those who have been interviewed. Thus, the independence of the members of SSB from *sukuk* issuers will promote assurance among investors whether that being with SABIC *sukuk* or other products in relation to Islamic financing.

The analysis in this research also evidenced, through participants' observation, the failure of SBSS in taking part in designing the structure. Among the risks which SABIC *sukuk* have been exposed is that the SBSS has failed to take part in designing *sukuk* structure in the first stage as it has been indicated by the members of SBSS. Consequently, those who have designed SABIC *sukuk* structure seem to be less knowledgeable in terms of *Shari'ah*, therefore the SBSS has discovered that the SABIC structure is exactly similar to the structure of *riba*-based bonds as has been indicated by one of the members of SBSS. Consequently, the failure of SBSS to take part in the original design will expose SABIC *sukuk* to many risks such as overlooking some of *Shari'ah* non-compliancy that cannot be easily discovered without close investigation through taking real part in the design. That has really been highlighted by the statements of the one of the SBSS members after the prospectus of SABIC *sukuk* has been presented to him; as after a detailed discussion he mentioned that SABIC *sukuk* has been containing some *Shari'ah* inconsistencies that has been missed by the SBSS. Thus, it becomes a duty that the members of SSB should make a real contribution in the design of the structure of *sukuk* and should be aware of all stages of *sukuk* including the real risks in *Shari'ah*, legal and financial terms to which

sukuk might be exposed and ways of avoiding those risks through *Shari'ah* and legal means.

As this study evidences in the empirical chapters, lack of clear method for the work of SBSS is found to be another risk issue to be considered. Neither AAOIFI standards nor the Islamic finance institutions, which SSB belong, have been subject to the method through which the *fatwa* can be issued. In other words, the uncertainty of the mechanism of approving SABIC *sukuk* is considered as one of the main concerns, which might lead to certain risks.

A major risk area is located by this research is the non-existence of a particular law for accountability. Failure to call members of *Shari'ah* boards to account in case of underperformance from their side, regarding their approval of structure of the products of Islamic finance, might expose SABIC *sukuk* structure to the risk of being inconsistent with *Shari'ah* principles. Accordingly, some of the interviewees believe that law and regulations must be made to incriminate those responsible for underperformance in some of *Shari'ah* boards regarding their approach of and shortcomings in the approval of the products of Islamic financing. However, having such a law in place will make SSB the best they could to follow reliable standards and procedures to approve the products such as *sukuk*. However, this suggestion will not be implemented, since there is no agreement between Islamic organisations in which rules and standards should be observed and followed with regard to *sukuk* structure and whether these rules and standards are binding or not. This is a macro-environmental issue that goes beyond one individual bank or financial institution or SSB; as the authorities as part of public policy should now consider developing the necessary legal and regulative environment for the efficiency of the market by also identifying the procedures for accountability.

Failure to observe AAOIFI standards in structuring *sukuk* is found to be another important issue leading to *Shari'ah* risk. As the discussion in the empirical chapters indicate, all SBSS members interviewed for this study have agreed that they were not fully committed to the standards as stated by AAOIFI with regard to *sukuk* given that they are members of AAOIFI. Subsequently, developing judgement on the structure of SABIC *sukuk* has based on the views and efforts of the members of SBSS rather than being subject to standards issued by considerable sources. Therefore, failure to

be committed to those standards will cause confusion in *fiqh* perspective between the various *Shari'ah* boards, which makes the structures on which SABIC *sukuk* has been designed are consistent with *Shari'ah* standards for one *Shari'ah* board and non-*Shari'ah* compliant for the other, as that has been asserted during the discussion in the previous chapter. Therefore, many demands are made by those who have been interviewed and others who are concerned about the Islamic finance that there must be some standards to be observed by all *Shari'ah* boards on which their judgment are made.

The empirical analysis presented in this research also evidences the concerns related to the failures of control and follow after *sukuk* have been approved. It should be noted that AAOIFI standards and the Islamic *Fiqh* Academy's Resolutions mentioned above have asserted that the *Shari'ah* board has to be involved in controlling as well as monitoring *sukuk* from the time of issuance until maturity, which is expected to provide guarantee of the performance of the product in a way consistent with *Shari'ah* principles and it will not veer from the right track of *Shari'ah* through close control and follow up by the members of *Shari'ah* board. However, in case of SABIC *sukuk* some of the members have indicated that they failed to follow up and monitor SABIC *sukuk* after it has been approved. Therefore, this indicates the existence of complacency, which has made *sukuk* to being consistent with *Shari'ah* principles and then latter it veers from *Shari'ah* track due to lack of those who control and follow up.

The risks associated with *fatwa* issued by the members of *Shari'ah* board need more concern, as this study established concerns over changing *fatwa* by one of the members of the board. When *Shaikh* Usmani stated that most of *sukuk* structures are inconsistent with *Shari'ah* principles, it seems there is no considerable efforts have been made by those concerned with issues in relation to Islamic finance and that the situation is still the same regarding *Shari'ah* boards that approving *sukuk* structures in terms of *Shari'ah* is left for *Shari'ah* boards without introducing a *Shari'ah* standards to be committed and binding for approval of *sukuk*. However, changing mind on *fatwa* or one of the members might change his views regarding the structure of a specific *sukuk*, constitutes a major *Shari'ah* risk to which SABIC *sukuk* might be exposed. Therefore, there is a possibility that one of the members of *Shari'ah* board that has approved SABIC *sukuk* might change his opinion to approve a product and,

which has actually happened with one of the members who believe that there are some non-*Shari'ah* compliancy issues in the prospectus of issuance of SABIC *sukuk*. However, some of others who were interviewed for this study suggested that some of the structures should be designed in advance by some experts which should be approved by AAOIFI or by other reliable sources so that all *Shari'ah* boards become committed to those structures and that should not give any chance to individual efforts by some *Shari'ah* boards that design a structure leading to *Shari'ah* non-compliance in real terms.

One of the effects resulting from lack of standards to be observed by *Shari'ah* boards is the confusion and differences in issuing *fatawa* by *Shari'ah* boards concerned with approving *sukuk* in the same country or in different countries. That will result in the announcement of approved *sukuk* by a considerable *Shari'ah* board and in the meantime other *fatawa* will be issued which tend to disallow the structure of the same *sukuk*. Thus, SABIC *sukuk* had been approved by a considerable *Shari'ah* board and in the meantime *Shari'ah* based criticism has been raised regarding SABIC *sukuk* structure by well reputed *Shari'ah* scholars in relation to the products of Islamic finance such as Merah (2011).

The difference in what is happening between *Shari'ah* boards in the same country or from one country to another will expose *sukuk* to lack of confidence by investors which might lead to the decrease in the price of *sukuk* due to being inconsistent with investors becoming aware of such differences. In other words, for example, if a *fatwa* issued by a prominent scholar explaining the fact that SABIC *sukuk* are inconsistent with *Shari'ah* principles, this will definitely affect its market price. Thus, it becomes dutiful that agreement has to be made between *Shari'ah* boards emphasising standards and general principles so that such type of risks should be prevented.

As the empirical evidence in this research shows, among the risks which SABIC *sukuk* have been exposed to are that some of the members of SBSS have been indifferent about reviewing all papers and documents relevant to SABIC *sukuk*. As one of members of *Shari'ah* board indicated during the interviews that it has not been 'important' to review all the documents in the presence of specialised committees that undertake the role of studying the structure in terms of *Shari'ah* before the structure to be presented to *Shari'ah* board for approval. On the other hand, another member has

indicated that the long prospectus of issuance could constitute an obstacle in addition to the language barrier so that reading the full prospectus of issuance is not needed. Thus, the fact that the SBSS only becoming aware of the summary of the prospectus of issuance will expose the SABIC *sukuk* to the risk of *Shari'ah* board not being aware of some inconsistencies with *Shari'ah* that have not been originally included in the summary of issuance prospectus. According to the SABIC *sukuk* prospectus "the majority of the Marketing Agreements provide SABIC with a non-exclusive right to market the relevant products". In addition, certain articles of the Marketing Agreements provide the relevant Specified Counterparty with the right to market and "sell its own products directly". In addition, if SABIC breaches any of its material obligations under a Marketing Agreement and such a breach is not remedied within the applicable grace period, then the relevant Specified Counterparty "may sell the relevant products directly to purchasers". In addition, the SABIC *sukuk* prospectus also stipulated that under Section (5) 'Termination' "The Marketing Agreements permit either party to *terminate the agreement if the other party is in breach of its material obligations*. Certain of the Marketing Agreements also permit either party to terminate it by advance notice to the other. In addition, certain Marketing Agreements are only for a specified term and any renewal of such agreements would depend upon the consent of both parties. Accordingly, "no assurance can be given that any of the Marketing Agreements will remain in force for the duration of the *Sukuk*". Therefore, it can be understood that the Marketing Agreements, which will generate the asset of SABIC *sukuk* can be revoked and cancelled. In other words, the "Applicable Percentage of certain specified rights and obligations under the Marketing Agreements for a period of 20 years", which represents the asset of SABIC *sukuk*, can be gone as long as the Marketing Agreements, which the *sukuk* assets based, have been cancelled. Thus, since there is no guarantee for the continuation of *sukuk* under the authority of *sukuk* holders due to the fact that the marketing contracts can be cancelled at any time. It should be mentioned that the lack of such important information in the summary of the SABIC *sukuk* prospectus that has been signed by SBSS, is considered as one of the main risk that *sukuk* holders are exposed to.

Before concluding this section, as a general observation and a key lesson drawn from the thesis in relation to *Shari'ah* governance issues is that *Shari'ah* governance issues are mainly faced in countries that do not have any regulatory framework. In other

words, Islamic finance sector in countries such as Saudi Arabia faces *Shari'ah* governance issue as such countries have not paid the necessary attention to develop the necessary regulatory framework dealing with specific issues arising from *Shari'ah* governance. Examining the developments in Malaysian Islamic finance sector shows that the Malaysian authorities have carried out extensive work in proactively developing the necessary regulations to prevent or at least minimise the potential problems might arise from *Shari'ah* governance in Islamic finance; as this is a very specific area of Islamic finance business. However, in Saudi Arabia and some other countries in the region, Islamic finance is only considered as a sub-set of conventional finance and therefore it is not regulated in relation to its own distinguishing characteristics, which includes *Shari'ah* governance issues. This indeed relates to larger regulative issues, as even in the regulation of the conventional banking and finance sector lack of necessary regulation seems to be a prevailing problem.

8.3 ANALYTICAL REFLECTIONS ON THE *SHARI'AH* RISKS ASSOCIATED WITH SABIC *SUKUK* STRUCTURE

After reflecting on the SBSS related risks as evidenced in the empirical chapters, this section presents a reflection on the *Shari'ah* risks associated with SABIC *sukuk* structure as established in the empirical chapters. As defined, any inconsistency with the rules and principles of *Shari'ah* will lead SABIC *sukuk* structure to the risk of *Shari'ah* non-compliance.

One of the findings established in the empirical chapters is that the structure of SABIC *sukuk* seems to be *riba*-based structure. After a close examination of the SABIC *sukuk* structure as well as its contents featuring a number of contracts and commitments and studying them in the light of *Shari'ah* principles and comparing them with some disallowed *riba* practices such as '*wafaa* sale contract' and '*amanah* sale contract', and since the validity of such selling practices in *Shari'ah* terms has already been explained as *riba* contracts, it could be concluded that the way SABIC *sukuk* structure was drafted is not different to the disallowed '*wafaa* sale contract'. It should be noted that as stated by the Islamic *Fiqh* Academy's Decision No 66 (4/7) regarding *bay' al-wafaa*; Decision No 188(3/20); Almenea (2011) and Merah (2011) such structure seems to be one of the tricks adopted to practice *riba* in reality.

Secondly, by reviewing the issuance prospectus and all documents attached to it, it could be argued that *sukuk* holders have not paid the necessary attention to assets and whether those assets have really existed. This implies that investors might be focusing on the credit worthiness of the issuer while overlooking the assets. In other words, investors' main concern was the financial solvency of the issuer (SABIC Company), as the capital and the periodic returns would be based on the SABIC Company. Therefore, the *sukuk* holders will pay attention to the source of guarantee, namely the SABIC Company rather than any other fact.

Another *Shari'ah* risk area that has been identified by this research in relation to SABIC *sukuk* structure is that the returns and assets seem to be irrelevant to one another. In other words, the method by which the profits for *sukuk* holders was worked out has not been explained in the issuance prospectus and by contrast *sukuk* holders have agreed to profit percentage that has been fixed for them by the issuer given that actual profits could be far more or could be less. However, as has been explained in the empirical chapters, *sukuk* holders are only concerned with guaranteed stable profit as has been assured by one of the members of the SBSS. Consequently, lack of relationship between the fixed profit percentage set by the *sukuk* manager (SABIC) and the actual profits produced by the project will create a doubt that the profits might have been produced by the issuer who has nothing to do with the assets not by the assets itself. This might expose *sukuk* holders to the risk of not gaining any profit in case of any failure or insolvency of the issuer, as the profit is originally produced by the issuer regardless of the performance of the asset. Thus, it becomes a dutiful that *sukuk* holders should receive the real profits based on the performance of their assets.

As has been explained in the empirical chapters, no real sharing in profit or loss might expose *sukuk* to become inconsistent with *Shari'ah* principles. It has become clear from the prospectus of issuance of SABIC *sukuk* that *sukuk* holders do not take part in the real profit in return of not being responsible of the loss of capital or otherwise the drop of profits from the approved ratio of the capital. Thus, it becomes dutiful that *sukuk* holders have to bear any lose against the profits they obtain as it has been discussed in the literature review according to '*al-ghonm bil gorm'*.

Having no real assets in SABIC *sukuk*, as established by this study, constitutes one of the major risks that *sukuk* holders might be affected from in case of bankruptcy or insolvency of the issuer (SABIC Company). It has become clear during the discussion that SABIC *sukuk* does not depend on assets or real 'rights' that can be assessed and evaluated. In addition, as found by this study, the assets of SABIC *sukuk* could neither be described as an a tangible assets as it has been noted by one of the SBSS or usufructs nor could be described as rights that could be assessed and sold, but instead it could be described as a future financial revenues generated from marketing services provided by SABIC to its subsidiary companies as would be explained by the prospectus of issuance. In this regard, the prospectus of issuance of SABIC *sukuk* stipulates that "SABIC has issued *sukuk* 1 and *sukuk* 2 worth SR 3 billion and SR 8 billion respectively), whereby 77.06 of the total marketing revues gathered by SABIC has been transferred to SPV in favour of *sukuk* holders" (PISS, 2008). This implies that SABIC *sukuk* represent the cash revenues to be generated from the marketing services. Therefore, the assets of SABIC *sukuk* are either the money itself to be collected in the future from SABIC subsidiary companies or the right of obtaining the money to be gathered in the future from SABIC subsidiary companies; however, in both cases the transaction is not *Shari'ah* compliant as it has been argued (*see:* Dagi, 2011; Merah, 2011; Almarshood, 2013).

Having no transfer of assets should be considered as an essential *Shari'ah* risk. As identified by one of the *Shari'ah* board members interviewed for this study, SABIC *sukuk* merely represents 'marketing rights'. However, these rights were not really transferred to *sukuk* holders as has been explained during the discussion in the empirical chapters; instead, it has been fixed on the issuer records as debts charged by the issuer. Therefore, *sukuk* holders become subject to losing their assets they own in case of bankruptcy or insolvency of SABIC Company. Thus, according to AAOIFI standards, it becomes a duty to do real transfer for what *sukuk* represents whether assets or as in our case 'rights'.

The existence of guarantying assets and profits, as has already been argued in the discussion, tends to expose *sukuk* to become inconsistent with the *Shari'ah* principles. For that reason, the issuance prospectus has to be free of any type of guarantee whether that guarantee becomes clearly made in form of promises given by the issuer

or by other parties who have been paid for that services or has any kind of business interest with the issuer as it has been stated by AAOIFI standards and the Islamic *Fiqh* Academy's Decision No 188(3/20).

As the empirical chapters established, the issuer owning the majority of the profits through reserve account constitutes an important *Shari'ah* risk. The presence of the reserve account is mainly to set the balance right and insure the regular generation of profits to *sukuk* holders. However, it should be noted that in case of SABIC *sukuk*, the reserve account has been established in the issuers' favour given that any amount that remains in the reserve account when *sukuk* expire will be given to the issuer as an incentive. Thus, it becomes dutiful that whatever remains in the reserve account when *sukuk* expire should go to *sukuk* holders as it is part of their ownership resulting from the assets they own.

Failure through underestimation of assets, how they have been assessed and whether that assessment has been real is another issue came out in the empirical chapters. By closely studying the prospectus of issuance, the method and mechanism of evaluating the underlying *sukuk*, which is the right of marketing the products, is unclear. Thus, *sukuk* holders become exposed to the risk of unfair evaluation of those rights in the market and whether or not those rights are really subject to evaluation in *Shari'ah* terms. However, as it has already been explained, *sukuk* holders are not concerned with the real value of what has been represented by *sukuk*, as the capital and profits are guaranteed.

The critical examination of the prospectus of issuance of SABIC *sukuk*, hence, empirically process that there exist major similarities between SABIC *sukuk* structure and *riba*-based bonds as depicted in Table 8.1.

Furthermore, the inconsistency between SABIC *sukuk* and AAOIFI standards is found to be another *Shari'ah* risk. From the further critical examination of the prospectus of SABIC *sukuk* issuance, it becomes obvious that the SABIC *sukuk* structure seems to be inconsistent with standards issued by AAOIFI as has already been mentioned in detail, which are summarised in Table 8.2.

8.4 ANALYTICAL REFLECTIONS ON FINDIGS RELATING TO THE LEGAL RISKS ASSOCIATED WITH SABIC *SUKUK*

The empirical analysis helped to identify a number of legal risks identified in the case of SABIC *sukuk,* which are reflected in detail as follows.

Absence of a special law featuring *sukuk* in Saudi Arabia is considered to be the main legal risks faced by Islamic capital markets in the country. As the CMA has a financial securities system including the conventional bonds, nonetheless, all the rules and regulations issued by the CMA have failed to provide a specific law related to *sukuk,* which might expose *sukuk* holders to the risk of treating *sukuk* as *riba*-based loan bonds. However, failure to differentiate between *sukuk* and bonds might lead to the risk failure of *sukuk* holders to become incapable of proving their rights regarding their ownership of the assets they carry. Consequently, it becomes dutiful to issue a special law regarding *sukuk* due to the fact the nature of *sukuk* from the legal aspect is different from *riba*-based bonds as has been explained and discussed in the previous chapter.

Table 8.1: Evaluation of SABIC *Sukuk* Comparing to *Riba* Based Structure (Bonds)

Bonds	**SABIC *sukuk***
The basic idea of *riba*-based bonds is linking the returns to the interest rates benchmark	SABIC *sukuk* returns are not linked to the actual profit of the asset but rather linked with the market interest rates.
Bonds holders always take the financial solvency of the issuer into account as the issuer gives them guarantee of their capital	It seems that *sukuk* holders consider the financial solvency of the issuer rather than *sukuk* assets in terms of its value and the revenues it generates, as the issuer gives them guarantee for the capital so that his financial solvency becomes important to *sukuk* holders.
No assets exist in case of bonds	SABIC *sukuk* do not represent the real assets, usufruct or services or otherwise 'rights' that can be financially assessed and evaluated in the market rather it represents future generated money or the right of collecting the future money.
The Capital and Returns are guaranteed by the issuer	The Capital and Returns are guaranteed by SABIC Company
A debtor-borrower relationship	It appears to be a relationship between a debtor and a borrower as no real assets exist to be owned by *sukuk* holders.
Low risk as the capital and returns are being guaranteed.	*Sukuk* is originally associated with high risk as the case with the shares as it features ownership and associated with an asset subject to gain or loss, and no guarantee is being given for capital or returns. However, as yet in case of SABIC *sukuk* the risk is law as it resembles the bonds in terms of the guarantee being given to the capital and the returns.
In case of bankruptcy of the issuer, then the bondholder should take his capital first hand, and then the remaining sums will be distributed between shares holders. However, in case nothing left, then the issuer will owe the capital to the bondholder.	*Sukuk* holders should originally go back to *sukuk* assets, and yet in case SABIC goes bankrupt *sukuk* holders have no right to take the contracts owned by SABIC as the right of disposal in form of marketing is owned by SABIC as the prospectus of issuance stipulates that; 'in case SABIC fails to undertake the marketing task or otherwise fails to give the periodic payments to *sukuk* holders, it should be committed to purchase those contracts which are actually not being owned by *sukuk* holders nor have they got the right of their disposal'. Moreover, SABIC is not allowed to transfer or otherwise sell those contracts as has already been mentioned according to the prospectus of issuance. However, there is no reference in the prospectus of issuance that *sukuk* holders have the right of taking the contracts to give them to another company in case SABIC goes bankrupt. On the contrary according to the prospectus of issuance, *sukuk* holders have no right of disposal of the contracts or even be given any information in relation to those contracts and agreements as has already been mentioned. The prospectus of issuance also does not refer to SABIC in case of bankruptcy and the subsequent fate of *sukuk* assets and the procedures associated with its transfer to *sukuk* holders and whether those assets to be shared by one of the debtors.

Table 8.2: The Inconsistency Between the SABIC *Sukuk* Structure and the Standards Issued by AAOIFI

	AAOIFI *Sukuk* Rulings	AAOIFI Ruling Reference	**SABIC *Sukuk***
1	'Investment *sukuk* represent a common share in the ownership of the assets made available for investment, whether these are non-monetary assets, usufructs, services or a mixture of all these, plus intangible rights, debts and monetary assets. These *sukuk* do not represent a debt owed to the issuer by the certificate holder'.	4(4/1) P 240	The SABIC *sukuk* represents 22.94% of the rights and obligations featuring the marketing agreements between SABIC and the subsidiary companies for 20 years.
2	'Investment *sukuk* are issued on the basis of *Shari'ah*-nominated contract in accordance with the rules of *Shari'ah* that govern their issuance and trading'.	4(4/3) P240	The prospectus of issuance failed to refer to that matter.
3	'The owners of these certificates share the return as stated in the subscription prospectus and bear the losses in proportion to the certificates owned (held) by them'.	4(4/5) P240	Sharing of gain and loss does not exist as there is a fixed profit for *sukuk* holders and the capital is guaranteed.
4	'The prospectus must include contractual conditions, adequate statements about the participants in the issue, their legal position and rights as well as obligations, such as statements about the issue agent, issue manager, originator, investment trustee, the party covering the loss, payment agent as well as others along with the conditions of their appointment and dismissal'.	(5/1/8/1) P242	The contracting conditions are not detailed involving generalisation and *gharar*.
5	'The prospectus of *sukuk* must include the identification of the contract on the basis of which the certificates are to be issued, such as sale of tangible leased assets, *Ijarah*, *Murabahah*, *Istisna'a*, *Salam*, *Mudarabah*, *Musharakah*, *Wakalah*, *Muzara'ah*, *Mugharasah* or *Musaqah'*.	(5/1/8/2) P242	The name of the contract is not mentioned clearly in the SABIC *sukuk* prospectus as there is disagreement between SBSS with regard to the name of the contract and the legal relationship between SABIC and *sukuk* holders
6	'The contract that forms the basis of the issue must be complete with respect to its elements and conditions not including conditions that conflict with its objectives and rules'.	(5/1/8/3) P243	The SABIC *sukuk* prospectus has failed to mention about this issue.
7	'The prospectus must explicitly mention the obligation to abide by the rules and principles of the Islamic *Shari'ah* and that there is a *Shari'ah* board that approves	(5/1/8/4) P243	No stipulation made by the prospectus of issuance that the SBSS must undertake the task of monitoring the

	the procedures of the issues and monitors the implementation of the project throughout its duration'.		*sukuk* in *Shari'ah* terms from the onset of issuance until maturation.
8	'The prospectus must state that each owner of a certificate participates in the profit and bears a loss in proportion to the financial value represented by his certificates'.	(5/1/8/6) P243	The SABIC *sukuk* prospectus has stipulated that there is fixed profits based on the LIBOR and if there is any default in the periodic distribution profits then SABIC will purchase the underlying *sukuk* at face value.
9	'The prospectus must not include any statement to the effect that the issuer of the certificate accepts the liability to compensate the owner of the certificate up to the nominal value of the certificate in situations other than torts and negligence'.	(5/1/8/7) P243	The capital of SABIC *sukuk* is clearly guaranteed.
10	'The prospectus must not include any statement to the effect that the issuer of the certificate guarantees a fixed percentage of profit'.	(5/1/8/7) P243	A clear guarantee of profits is given from SABIC company to the *sukuk* holders.
11	'It is permitted to an independent third party to provide a guarantee free of charge, while taking into account item 6/7 of *Shari'ah* standard No. (5) in respect of guarantees'.	(5/1/8/7) P243	It has been argued by one of the members of SBSS that SABIC company is considered as a third party as this is the reason for the guarantee promised by SABIC company.
12	'It is permissible for the issuer or the certificate holders to adopt permissible methods of managing risk, of mitigating fluctuation of distributable profits (profit equalization reserve), such as establishing an Islamic insurance fund with contributions of certificate holders, or by participating in Insurance (Takaful) by payment of premiums from the income of the shares of *Sukuk* holders or through donations (*tabarru'at*) made by the *Sukuk* holders'.	(5/1/11) P243	The reserve account has been established. However, the excess of profits will go to the manager as an incentive as well as the manager has a right to invest what is in the reserve account for himself.
13	'In the case of negotiable *sukuk*, it is permissible for the issuer to undertake, through the prospectus of issue, to purchase at market value, after the completion of the process of issue, any certificate that may be offered to him, however, it is not permissible for the issuer to undertake to purchase the *Sukuk* at their nominal value'.	(5/2/2) P244	A clear provision exists regarding the promise to buy at the nominal value as the calculation that SABIC made in the prospectus indicate that after five years SABIC will purchase the underlying SABIC *sukuk* at 90% plus 10% as extra from the reserve account.
14	'The certificates may be traded through any known means that do not contravene the rules of the *Shari'ah*, such as registration, electronic means or actual transmission by the bearer to the purchaser.	(5/2/3) P244	None of these methods have been used as the assets are still in the record of the issuer.
15	*'Sukuk*, to be tradable, must be owned by *Sukuk* holders, with all rights and	*Sukuk*	The ownership of the assets did not meet all the

	obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally as well as in accordance with the rules of *Shari'ah*, in accordance with Articles (2)1 and (5/1/2)2 of the AAOIFI *Shari'ah* Standard (17) on Investment *Sukuk*. The Manager issuing *Sukuk* must certify the transfer of ownership of such assets in its (*Sukuk*) books, and must not keep them as his own assets'.	recomme -ndations No (1)	*Shari'ah* rules as there is no control over the assets and there is no real transfer of the assets
16	'It is not permissible for the Manager of *Sukuk*, whether the manager acts as *Mudarib* (investment manager), or *Sharik* (partner), or *Wakil* (agent) for investment, to undertake to offer loans to *Sukuk* holders, when actual earnings fall short of expected earnings. It is permissible, however, to establish a reserve account for the purpose of covering such shortfalls to the extent possible, provided the same is mentioned in the prospectus. It is not objectionable to distribute expected earnings, on account, in accordance with Article (8/8)3 of the AAOIFI *Shari'ah* Standard (13) on *Mudarabah*, or to obtaining project financing on account of the *Sukuk* holders'.	*Sukuk* recommend -ations No (3)	There is no undertaking of offering loans to *sukuk* holders in the prospectus of SABIC *sukuk.*
17	*'Shari'ah* Supervisory Boards should not limit their role to the issuance of fatwa on the permissibility of the structure of *Sukuk*. All relevant contracts and documents related to the actual transaction must be carefully reviewed {by them}, and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with *Shari'ah* guidelines and requirements as specified in the *Shari'ah* Standards. The investment of *Sukuk* proceeds and the conversion of the proceeds into assets, using one of the *Shari'ah* compliant methods of investments, must conform to Article (5/1/8/5)7 of the AAOIFI *Shari'ah* Standard (17)'.	*Sukuk* recommend ations No (6)	Failure of SBSS to undertake the task of supervision and monitoring of the SABIC *sukuk* as the role and task of the SBSS terminates at the endorsement of the issuance prospectus

The empirical analysis shows that the legal position of *sukuk* holders is unclear, which is due to the absence of law for *sukuk* as has already been discussed given that *sukuk* holders will be confused whether they own the assets or otherwise become lenders; and each of the two situations has its own legal consequences. Thus, the vague legal situation of SABIC *sukuk* holders might expose *sukuk* holders to become incapable to prove their right of ownership of their assets as well as the income of those assets that they are supposed to own as part of the money given by the other lenders, as their relationship with the issuer represents that between lender and borrower as the case with traditional bonds.

As has been explained in the empirical chapters, Saudi *sukuk* market has not experienced any failure of any *sukuk* issued yet. In this regard, according to the interviews that were conducted some interviewees believe that *sukuk* holders are capable to prove their ownership of the assets that they have bought from the issuer in case the issuer has gone bankrupt. However, by contrast given that *sukuk* are modern in the Saudi market and it has not been tested to find out the extent of the capability of *sukuk* holders to prove their ownership of assets that they carry as no previous cases of failure in the Saudi market have reported that can be considered as a precedent and a reference to find out the capability of *sukuk* holders to prove their ownership. In addition, as it has been mentioned in the empirical chapters, there is no law exist in the Saudi financial market that differentiates between *sukuk* and *riba*-based bonds and all that will make *sukuk* holders become exposed to the risk of losing their assets.

The findings also suggest that resorting to the non-*Shari'ah* courts or committees remains an issue to be resolved. *Shari'ah* constitutes the foundation of the Saudi Arabian constitution. As has already been mentioned, the Committee of the Resolution of Securities Disputes is the panel authorised to investigate cases associated with *sukuk* and yet given that that panel has no judiciary status in the sense its members are not *Shari'ah* judges. Therefore, the judgment issued by those people who are not specialised in *Shari'ah* law is considered one of the risks that *sukuk* holders might expose to.

As it has already been mentioned that among the risks facing SABIC *sukuk* holders is that the SBSS decision might not be observed by neither *Shari'ah* courts nor the CRSD due to observed inconsistency with *Shari'ah* rules. Thus, it becomes dutiful that the approval of *sukuk* should

initially be from specialised centres in accordance with observable standards, as has already been explained. In addition, commercial courts have to be established with its members from *Shari'ah* judges who are experienced in Islamic finance and that those courts should be in charge of such conflicts in relation to case featuring *sukuk* and other money exchange issues.

Another issue that is located as a potential risk area is the failure to observe *Shari'ah* board decisions. In other words, among the risks to which SABIC *sukuk* has been exposed is the probability that the decisions of *Shari'ah* board that approved SABIC *sukuk* will not be executed as that has been provided by the prospectus of issuance which has been explained before. In other words, the contract on which *sukuk* has been established might be invalidated by the ACRSC and that all or at least some of issues featuring the prospectus of issuance regarding the rights of *sukuk* holders might not be of any interest given that the decisions of the *Shari'ah* board is not observable by the ACRSC. Thus, it becomes essential that *fiqh* decision should be transparent and there is a need for *sukuk* structures to be approved by *Shari'ah* boards and dispute panel to avoid conflict in opinions and inconsistency in views as to resume trust of investors in *sukuk.*

Lack of dependence of the CRSD and ACRSC from the CMA is found to be another essential issue causing potential risk. In other words, among the legal risks is that the members of the dispute panels, who are authorised to investigate any dispute featuring *sukuk,* have been appointed by the CMA. In this regard, if there is any legal dispute between CMA and SABIC *sukuk* holders, then there is a possibility that the members of the ACRSC will become biased in their judgment to the view of the CMA, since those members receive their salary from CMA. Thus, it becomes dutiful that CRSD and ACRSC have to have some sort of independence to avoid conflict of interests between the CMA and the dispute panels and also keep the rights of *sukuk* holders from being lost.

The existence of numerous judiciary bodies to investigate cases of dispute in Saudi Arabia should also consider creating a particular risk area. It is known that the CRSD and ACRSC represent the body in charge of cases of dispute with regard to *sukuk.* In this respect, the main risk is that investors in SABIC *sukuk* could find another legal body to investigate cases such as *Shari'ah* courts or *Dewaan Al-mathalem* (Grievance Board) as indicated by one of the

interviewees. Consequently, one body might conclude with an opposite decision to the other, as there might be dispute between those bodies over who might be in charge to investigate such cases. Thus, having said, the special commercial courts should provide the legal solution along with developing the necessary *Shari'ah* terms to cope with such risk.

Imperfection of contract on which the issuance prospectus is based in legal terms is found to be another risk exposure area. The prospectus of issuance of SABIC *sukuk* featuring the legal contract between *sukuk* holders and the issuer seem to be defective in legal terms. However, the prospectus fails to explain the nature of contract relationship between the issuer and *sukuk* holders as has already been mentioned during the discussion. Thus, the legal nature of *sukuk* holders whether they are buyers or otherwise renters might be vague in the sense as to whether SABIC Company has severed relationship with assets that it has sold in legal terms or that relationship is considered as a third party relationship featuring a free service as that has already been mentioned during the discussion. In this regard, according to the balance sheet of SABIC company as well as the guarantees which have been given from SABIC (Issuer) to the *sukuk* holders, it seems that SABIC as an Issuer still have the authority upon the underlying SABIC *sukuk* asset which mean there is no real sale has taken place. However, that vagueness and lack of transparency might expose SABIC *sukuk* to many legal risks that have already been explained in the discussions in the earlier chapters. Consequently, the design of prospectus of issuance in perfect legal terms tends to protect *sukuk* holders from being exposed to potential legal risks as it has been suggested by the Islamic *Fiqh* Academy' Decision No 188(3/20).

The analysis in the empirical chapters show that there has been no mention of what it has been sold to *sukuk* holders, which indicates another risk exposure area. This implies that what has ever been sold to *sukuk* holders is considered one of the issues of conflict between the members of SBSS. In other words, whether SABIC *sukuk* represent privilege contracts or marketing contracts or otherwise giving the right for marketing or SABIC *sukuk* represent money to be collected in future or they might represent the right to earn the deserved amounts of money. However, it should be mentioned that what it has been owned by *sukuk* holders has not been explained clearly in the prospectus of issuance, which hence represents a major risk to which SABIC *sukuk* holders are exposed in case of insolvency of SABIC.

The legal transfer of assets is found to be another area of risk exposure. Among the legal risks that SABIC *sukuk* holders has to cope with is that there is no legal document that prove their ownership of the assets featuring their *sukuk* as the documents indicate that the assets still appear in the issuer's balance sheet and have not been transferred to the records of *sukuk* holders. Thus, as has been already explained in the discussion it becomes dutiful that a full transfer of assets has to take place from the issuer records to *sukuk* holder's records.

Failure to estimate the real value represented by SABIC *sukuk* is found to be another important issue. As a matter of fact, the prospectus of issuance of SABIC *sukuk* has not explained the method of evaluation the underlying assets. This might create a doubt, as it has been pointed out by one of the interviewee that SABIC Company might have evaluated the underlying assets according to the fund that needed. In another words, how the *sukuk* holders be insured, and the value of the SABIC *sukuk* is accurate according to the market expectation since there is no explanation in the prospectus. Consequently, *sukuk* holders may get shocked when they find the value of the *sukuk* are not true in the case of dispute. Therefore, as a consequence, the prospectus of issuance has to explain the methods by which SABIC *sukuk* has been evaluated and who has undertaken that task.

Failure of *sukuk* holders to review all documents is another essential problematic issue as established in this study. *Sukuk* holders retain the right to review the prospectus of issuance and all the relevant documents particularly marketing contracts signed between SABIC and its subsidiary companies. Nonetheless, the prospectus of issuance SABIC *sukuk* has provided that some documents have to be inaccessible or otherwise no copies have to be provided which is considered among the risks to which *sukuk* holders are exposed to. Hence, it will be dutiful that *sukuk* holders have to review all documents that some of which might be not in their favour.

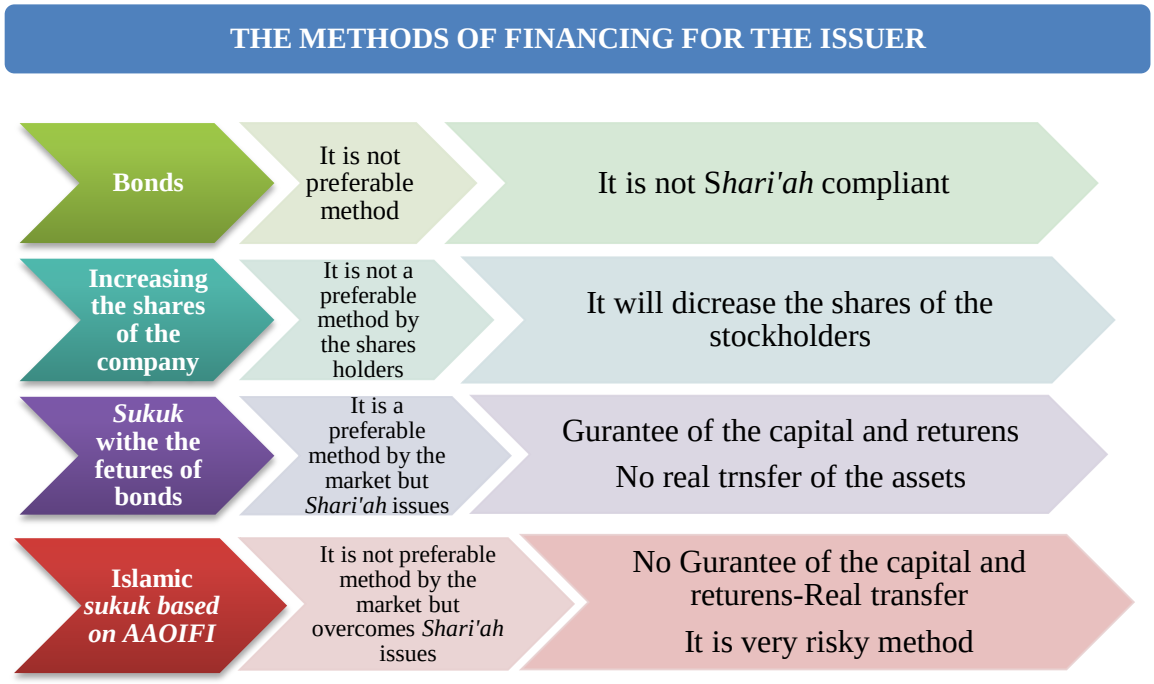
Another potential risk area emerged from critical discuss is the SPV related issues. The main aim of establishing SPV as part of *sukuk* structure is to maintain the assets of *sukuk* away from being controlled by the issuer in case of bankruptcy. However, as it has been discussed in the empirical chapters, the establishment of a proper SPV is yet to be developed in the Saudi market. Nonetheless, it is noteworthy that SPV represents a company affiliated to the issuer (SABIC Company), which indicates that the assets are still under the authority of the issuer. Thus, the

CMA has to facilitate the procedure to establish such companies to represent a legal entity through which the rights of *sukuk* holders can be maintained.

8.5 OVERALL REFLECTIONS ON THE FINDINGS

It should be mentioned that developments and trends in *sukuk* market make it clear that there is great need for companies to issue *sukuk* as one of the methods of Islamic financing. Some investors show interest in the Islamic *sukuk* for their consistency with *Shari'ah* principals. Thus, as depicted in Figure 8.1, the companies and investors in general have so many methods of funding and investment, which includes Islamic financing ad well as *sukuk* along other sources. This section aims to evaluate their potential impact for business, as follows:

Figure 8.1: The Methods of Financing for the Issuer



(i) Financing through issuing *riba*-based bonds. This method seems to be preferable by all investors as it is less risky even though it is inconsistent with *Shari'ah* principals;

(ii) Raising financing through increasing the capital and allowing new investors to become shareholders. This method is not popular among the main shareholders of companies as that will decrease their profits;

(iii) Raising financing through investing in the stock market. The investment in the stock market is highly risky as no guarantee is given for neither the capital nor the profit, and for that reason this method is unpopular among companies as most companies are looking for the stable profit with guarantee of the capital;

(iv) Raising financing through issuing *sukuk* with same features of *riba*-based bonds. This is due to the fact that most of *sukuk* that have been issued nowadays are similar to *riba*-based bond structure in terms of the guarantee given to capital and profit, and dependence on the benchmark to estimate the profits, not to mention the fact that in most designed structures, there is no transfer of the assets from the issuer to *sukuk* holders as it has been mentioned by Usmani (2007) and Merah (2011). Nonetheless, those structures have been designed to respond to the demand of the companies looking for liquidity as well as investors who are also looking for less risky investment. In other words, the current problem with most *sukuk* structures is that the *sukuk* structure features a complex combination of contracts, promises and conditions. Thus, by examining each component of this combination in terms of *Shari'ah* might prove to be right. However, there might be *fiqh* dispute among scholars in some of the contracts, promises or conditions in terms of *Shari'ah*. While some consider them as reliable and right, but the problem is not the inconsistency of contracts, promises and conditions with *Shari'ah* principals as at least some consider them consistent with *Shari'ah* as has already been mentioned. However, the main problem is that such component structures featuring contracts, promises and conditions will produce the same outcome as *riba*-based bonds, in terms of structure. However, it could be argued that many such *sukuk* structures have been approved by *Shari'ah* boards, which could be due to the fact that the *Shari'ah* boards have been concentrating on the details of the structure featuring contracts, promises and conditions and their consistency to *Shari'ah* principals without reviewing the results and the consequences given that such combination has resulted in a similarity of that structure to the structure of *riba*-based bonds in terms of guarantees, disallowance of transfer of the assets and dependence on benchmark to estimate profits. For that reason, Usmani argues that almost 85% of *sukuk* structures are inconsistent with *Shari'ah* principals (Shaikh and Saeed, 2010). Due to such reasons that Almenea, who changed his mind on his *fatwa* or judgement in relation to Bahraini Airline *sukuk* on the ground that the consequences of the structure of Bahraini Airline *sukuk* that has been approved by SSB have been similar to the outcome of the *riba*-based bonds*;* therefore, Bahraini Airline *sukuk* are

disallowed. In overall, Usmani, Almenea and Merah argue that most of current *sukuk* structure seems to be inconsistent with *Shari'ah* principles;

(v) Issuing *sukuk* in line with AAOIFI standards. This kind of *sukuk* will neither be accepted by corporations seeking funding nor will it be accepted by investors in the financial market for two reasons:

(a) Such kind of *sukuk* is associated with high risk due to lack of guarantee in terms of capital and profits. Consequently, investors in this case prefer to invest in stock market instead *sukuk* market given the high returns in investing in stocks compared to *sukuk*.

(b) This kind of *sukuk* requires a condition to be set that there must be real transfer of assets to be sold by the company to *sukuk* holders. Thus, it follows that in such case it will be better for the company' shareholders to increase the capital rather than selling part of the assets of the company that will affect the value of the company in the market. Thus, it could be argued that SABIC Company has managed to make three trunks of issuances, which have been successfully sold in the market for many reasons. First of all, SABIC Company is considered one of the largest companies in Saudi Arabia, therefore, the robust reputation for SABIC in the Saudi market led investors to be confident towards SABIC *sukuk*. In addition, the SABIC *sukuk* structure has been designed to be less risky due to the promise given by the issuer to purchase at the nominal value and the profits have been set based on the LIBOR and that is exactly what investors are looking for. Furthermore, in SABIC *sukuk* structure, the issuer (SABIC) has not been obliged to sell anything of its assets or sell his marketing rights of the production of the subsidiary companies of SABIC, over which in fact the issuer has no right to sell these rights as it has been stipulated in the prospectus of SABIC *sukuk*. In another words, what it has been sold is the right to obtain future gains featuring a certain percentage of the marketing process of the products of SABIC subsidiary companies as it has been discussed in the empirical chapters. In addition, another reason is that, SABIC has established a subsidiary company as a SPV to undertake the task of keeping the assets a matter that has made it easy for the assets to remain in the records of the issuer and under SABIC

control. Finally, among the reasons is that SABIC *sukuk* has been approved by a *Shari'ah* board featuring the most reputed experts in Islamic finance in Saudi Arabia.

According to the above, it could be argued that the market remains significantly in need for a product that should satisfy all parties, and that such product should be less risky and at the same time should be consistent with *Shari'ah* principles. On the other hand, for instance, that product should not match the bonds in terms of structure and outcome in terms of the guarantee given to capital and profits. However, having said that, the most suitable contract to satisfy such description is the *ijarah* contract not 'sale and lease back contract' as it has been suggested by Merah (2008,2011), as such structure makes *sukuk* resembling to *enah* sale as well as leading to *wafaa* sale, both of which are disallowed as has already been explained. Therefore, companies which seek for fund should concentrate on their needs whether buildings, goods, materials or something to be manufactured rather than focusing on how to obtain cash money. In this case, under *ijarah sukuk* agreement, investors through a specific agent will receive an order that a particular company needs materials or goods based on certain qualities and features. Then, the investors will provide all these requirements and then will lease it to these companies to fill their needs. Thus, such contract will be less risky as it will lead to a real economy based *sukuk* in line with *Shari'ah* principles.

8.6 RECOMMENDATIONS

In this study, the *Shari'ah* and legal risks associated with the SSB and SBSS as well as with the SABIC *sukuk* structure are critically discussed through deconstructing the components and articulations of SABIC *sukuk.* The discussion and findings are presented the empirical chapters and this chapter provided further critical reflections on the findings so far. Based on the analysis and the findings of this study, the following suggestions and recommendations are developed with the objective of enhancing the reputation of the Islamic finance industry in Saudi Arabia and in particular in the Saudi capital and financial markets:

(i) It is essential that *sukuk* should be based on uncomplicated Islamic contracts and the structures of these contracts should not lead *sukuk* to be against the principles of *Shari'ah*;

(ii) It is also necessary that the regulatory and legislative bodies in a Muslim country such as Saudi Arabia should provide a suitable legislative and regulatory environment for the issuance of *sukuk* taking into consideration the legal and *Shari'ah* risks that *sukuk* structures might be exposed to;

(iii) Based on the findings, the CMA should issue a special law and regulations for *sukuk* to differentiate between Islamic *sukuk* and conventional bonds, as there is no specific law for *sukuk* formalised in the country yet;

(iv) As the findings indicate, unified *Shari'ah* legitimacy body should be established in every Muslim country especially in Saudi Arabia with full authority in reviewing and monitoring all the issuances of *sukuk*. This standardized *Shari'ah* and legal committee should have a positive impact in reducing the negative impact of *fiqhi* differences to increase confidence in the Islamic financial products;

(v) The duty of the SSB should be extended to participate in the formulation of structuring the *sukuk* and following up from the beginning of the *sukuk* issuance until the maturity.

8.7 LIMITATIONS AND FUTURE RESEARCH

Although the researcher has put his utmost effort to develop and produce a reliable, comprehensive, critical and significant research on the subject of *Shari'ah* and legal risks faced by *sukuk* issued in Saudi Arabia, it cannot be denied that this study has experienced several research limitations.

First of all, the literature on the topic of *Shari'ah* and legal risks in *sukuk* structures extremely limited which caused difficulties in deconstructing the conceptual framework of the *Shari'ah* and legal risks in *sukuk* structures.

Secondly, a small number of interviewees were considered another limitation when it comes to the legal side particularly. However, considering that these interviews were in-depth and elite interviews, and the sampled individuals are rather highly reputable and authoritative individuals, it is hoped this should not be considered as a limitation.

With regard to the textual method, the results might not be robust as the time period of analysis is limited, involving only information and data for just one prospectus, which is SABIC *sukuk* as well as having one case study from Saudi Arabia. However, considering the detailed and extensive analysis provided with critical approach through the insider insight provided by the participants, it is hoped that such a limitation in reality has been overcome.

As regards to future research, the present research limited the scope of study by concentrating on the legal and *Shari'ah* risks. In this respect, the scope of this research could be extended further to the financial risks as well as involving more *sukuk* issuances in Saudi Arabia in the future research. In addition, since there are many banks and companies seeking finance through an Islamic *sukuk,* one of the areas that need to be covered and developed is that designing many different types of *Shari'ah* compliant structures based on Islamic contracts so that the specific demands can be responded with such Islamic structures.

Regardless of these limitations, it should be strongly claimed that this research has fulfilled the research aims, objectives and the research questions.

8.8 EPILOGUE

The primary contribution of this research is the exploration and examination of the *Shari'ah* and legal risks associated with *sukuk* structures that have been issued in Saudi Arabia. In this regard, a critical review and investigation were conducted on the most important *sukuk* issuance, which is SABIC *sukuk,* in Saudi financial market.

In addition, the study discussed and analysed the SABIC *sukuk* structure by highlighting the essential *Shari'ah* and legal risks that SABIC *sukuk* exposed to whether these risks are related to the function of the SBSS or the nature of the contract which the SABIC *sukuk* structure is based on.

Furthermore, the study contributed to the development of a methodology for identifying and evaluating the extent to which the current practices of *sukuk* fulfil the principles of *Shari'ah* in line with AAOIFI standards. In addition, the justifications of the Saudi *Shari'ah* scholars on the practice of SABIC *sukuk* structure have been analysed. Moreover, the existing gaps in the legal

framework and financing structures potentially leading to legal risks for SABIC *sukuk* have been also identified.

It should also be noted that this research also contributes to the understanding and knowledge of managing the *Shari'ah* and legal risks associated with *sukuk* structures by developing some main evaluation parameters when any issuance needs to be examined and investigated.

Although the empirical findings do not reflect a positive *status quo* of Islamic finance, it is hoped that the results from this research can be utilised to facilitate the improvement as well as development of IFB sector by emphasising the importance of following the principles of *Shari'ah* not only through *fiqh* but also in moral sense. In addition, further implementation of the *Shari'ah* standards such as AAOIFI is the best way to overcome any potential financial failure in the industry and reconceptualise the role of Islamic finance in the Islamic financial markets.

Lastly, as this brief summary in this section indicates, the research has fulfilled its aims, objectives and research questions set in the beginning of the journey; which brings this research to an end (at least for the time being).

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Appendix 1

INTERVIEW QUESTIONS (ENGLISH)

Questions for *Shari'ah* Board who Approved SABIC *Sukuk* (SBSS)

(i) The function of the SBSS and important related issues with regard to SABIC *sukuk*:

(1) What is the function and role of the *Shari'ah* board drafting the structure of *sukuk*, and whether it undertakes the drafting the structure of sukuk, or is that function limited only to the review and approval of the structure of SABIC *sukuk*?

(2) Does the *Shari'ah* board become aware of all the documents in relation to *sukuk* issuance (commitment to purchase, ownership transfer and management agreements of *sukuk* assets, *etc*)?

(3) What are the documents that the *Shari'ah* board should be aware of before issuing the *fatwa*?

(4) Does the *Shari'ah* board itself commit and follow the AAOIFI standards?

(5) Does the *Shari'ah* board undertake its duties of supervision, control and follow up in accordance with AAOIFI standards?

(6) Does the *Shari'ah* board take its decision by simple majority or by consensus?

(7) Do you agree with the idea of standardisation of *sukuk* issuance (such as AAOIFI standards)?

(8) Are there any problems or barriers associated with the implementation of AAOIFI standards in Saudi Arabia? What are those problems?

(9) As you know *fatwa* could change before the maturity of *sukuk* (sometimes from the same *Shari'ah* board that has approved the *sukuk*). In this case, what is required from the *sukuk* holder and what they have to do?

(10) Has there been a clear observance of *Shari'ah* principles regarding the issuance brochure?

(ii) The Structure of SABIC *Sukuk*:

(1) What is the structure of SABIC *sukuk* and the nature of the contract?

(2) Is it important that the name and the nature of the contract should be mentioned in the prospectus? (In the prospectus, it has been mentioned that the contract is called marketing contracts, so what type of marketing contracts SABIC *sukuk* belong to?

(3) How does the *sukuk* issued by SABIC differ from its initial conventional bonds?

(4) Who are the various parties in the SABIC *sukuk*, and what are their obligations and rights and whether they should feature in the prospectus?

(5) Is there any determination and differentiation from financial commitments side (financial disclosure) between SABIC and its subsidiaries which SABIC signed with them the marketing contracts or they are same?

(6) Does the coverage contractor (most likely the bank) claim commission in return for the service it provides, and whether that would be allowed by *Shari'ah*?

(7) Do *sukuk* holders and *sukuk* issuers really share the gain and loss?

(8) Is the return on *sukuk* determined by *sukuk* assets as well as the expected revenues from those assets? Or otherwise depending on the financial convenience of the issuer (the traditional bonds)?

(9) Why is the financial solvency of the issuer more important than sukuk assets (for the investor), given that the *sukuk* assets and their revenues are independent of the *sukuk* issuer (SABIC).

(iii) *Sukuk* assets:

(1) What are the assets of SABIC *sukuk*?

(2) Is there a real transference of *sukuk* assets from the issuer to *sukuk* holders? If so, how could that transference take place from *Shari'ah* perspective?

(3) Do the periodical profits given to *sukuk* holders always consistent with the *sukuk* assets and according to the performance of the assets of *sukuk*? Or that is only determined by the market interest rates rather than the nature of *sukuk* assets?

(4) It is noteworthy that the profits given to *sukuk* holders are linked to the market interest rates as well as the financial solvency of the *sukuk* issuer rather than the performance of the assets of sukuk itself. Should that be an indication of the fact that the existence of *sukuk* assets is a formality?

(5) It is noticeable that the *sukuk* values after circulation in the secondary markets are not affected by the value of *sukuk* assets, but rather affected by the periodical batches of *sukuk* as well as the market interest rates. In another words, there is no real link between the value of *sukuk* and the assets of *sukuk*. Does not that also indicate the existence of sukuk assets is a formality?

(6) The *sukuk* assets are controlled by the *sukuk* issuer (SABIC), and also the trustee of the *sukuk* assets is a company affiliated to the issuer. Does not that indicate the formality of *sukuk* structure as the *sukuk* holders have no real assets that could be considered in case of insolvency of the issuer or otherwise its failure to meet to its financial commitments?

(7) In case of insolvency or failure of SABIC to meet its financial commitments towards *sukuk* holders, what are the assets of SABIC *sukuk* (Marketing contracts) that could be considered and claimed by the *sukuk* holders?

(8) Does SABIC continuously sign marketing contracts with its subsidiary companies or does it do that only when the need arises to create assets to issue sukuk (formality of assets).

(iv) Capital guarantee and returns (recovery of *sukuk*):

(1) Has the *sukuk* issuer (SABIC) the right to make an undertaking to *sukuk* holders to purchase the *sukuk* assets at the nominal value? Or otherwise at a certain percentage (90%) within a specific period of time?

(2) SABIC gives the right to *sukuk* holders to recover their *sukuk* every five years at the face value not at the market value. As a matter of fact that will be inconsistent with AAOIFI standards? What is your opinion?

(3) When the *sukuk* expire, should *sukuk* holders sell the *sukuk* assets to the issuer at the face value or based on the market value?

(4) What is the source of payments for *sukuk* holders? (Where did the profits come from?).

(5) Why does the issuer have no right to grantee the capital and the returns, while an independent third party has the right of capital assurance in favour of *sukuk* holders?

(6) Has the Saudi government (or any of its organisations) as an independent third party the right to grantee the capital of SABIC *sukuk*, given that they owned 70 % of the SABIC capital?

(7) SABIC considers its delay of fulfilling its financial commitments to others as a sign of failure to deal with *sukuk* holders as it has been mentioned in the prospectus, and accordingly *sukuk* holders have the right to claim the full recovery of *sukuk* from SABIC at the face value. But the question is whether the *sukuk* assets and their revenues is an independent matter from SABIC (not part of SABIC financial commitments), why SABIC as an issuer is still interfere while SABIC sold its assets (marketing contracts)?

(8) Failure to give out the periodical distribution payments to *sukuk* holders is considered one of the failures of SABIC to deal with *sukuk* holders in which case the latter have the right to claim their money back from SABIC and the repurchase of *sukuk* at the face value. Eventually, that should mean SABIC would be committed to pay the periodic distributions to the *sukuk* holders whereas there is no link between SABIC and *sukuk* holders. How do you comment on that?

(9) Why does SABIC label its *sukuk* as debts in its balance sheet? How do you comment on that?

(v) Profit Reserve (distribution rate):

(1) What do you think about reserves of retained earnings to be controlled by the *sukuk* issuer (director of *sukuk* assets)?

(2) Are *sukuk* holders being briefed on the periodic profit rates as well as profit reserve for them?

(3) The director of assets (also he is the *sukuk* issuer) has the right to deal with the reserve profits in his own account, and that all the reserve money will go into his pocket at the end of the period as a bonus (provided that he has made all the periodic payments to *sukuk* holders). Comment on that.

(4) The fact that the profit reserves go to the issuer (or the director of assets) and that the profit is predetermined that the *sukuk* holders will have limited profits with a maximum as agreed upon in the prospectus. However, the loss will be unlimited for *sukuk* issuer, while they would obtain funding without taking any risks or any commitments regarding the periodic payments (only he has to pay form *sukuk* assets). Comment on that.

(5) It is common knowledge that *sukuk* are circulated in secondary markets, so how do they determine the share of new *sukuk* holders as a percentage from the profit reserves? Also, who has the right of ownership of the reserves the seller or the new buyer?

(vi) The *Qhrar* (Ambiguity):

(1) How do the *sukuk* assets and their market value become well known value and price for the issuer himself and the *sukuk* holders?

(2) Does the market value of *sukuk* assets an exact equivalent of the purchase value to be paid by *sukuk* holders?

(3) Do *sukuk* holders become aware of the market value of *sukuk* assets which they are going to buy, and what are the expected revenues from those assets, and the nature of the contracts involved (in relation to *sukuk* assets) between SABIC and its affiliate companies, and what are the companies involved in the marketing contracts with SABIC?

(4) In case of significant variation between the face value and the market value of the sukuk assets when *sukuk* expire (because the issuer when he sold the assets to *sukuk* holders, he did not value the assets correctly), have *sukuk* holders got the right to claim compensation from the issuer regarding the damages they have sustained?

(5) Is there any risks involving *sukuk* (lack of knowledge of the assets featuring *sukuk*, its market value, and its revenues)?

(vii) *Sukuk* assets and the use of subscription output:

(1) Should *sukuk* assets be 100 % consistent with *Shari'ah* principles? Some would argue that *sukuk* assets that are inconsistent with *Shari'ah* should not exceed 33 % of the total value of *sukuk* assets. What do you think of that?

(2) Should the subscription output be used for purposes 100 % consistent with *Shari'ah*? Some would believe that the use of subscription output for purposes inconsistent with *Shari'ah* should not exceed 33 % of the total subscription output. What do you make of that?

Questions for Legal Participants

(1) What are the main differences between bonds and *sukuk* from legal perspective?

(2) Are the *sukuk* in Saudi Arabia asset-backed *sukuk* or asset-based *sukuk?*

(3) Do the *sukuk* holders have full right of ownership over their assets? In other words, is the transferring of ownership of the assets from the original owner to the *sukuk* holder met all legal rules and requirements?

(4) In case of bankruptcy, what is the legal position of *sukuk* holders?

(5) How they can claim their rights?

(6) Is there any specific law regarding bankruptcy?

(7) What are the risks that might happen?

(8) How can we manage the risks associated with the uncertainty of the law in Saudi Arabia in terms of the process and the procedures that *sukuk* holders should go throw after any default?

(9) Do you think that there is a lack of legal experts who have *Shari'ah* and legal specialisation in financial matters such as *sukuk?*

(10) What are the consequences of this upon *sukuk* market?

(11) What are the legal implications of the risks of multiplicity of jurisprudence *fatawa*/verdicts?

(12) What is the effect of the differences in *fatwa* between the *Shari'ah* committee of SABIC *Sukuk* and the Members of CRSD and ACRSC in various matters?

(13) Is it true that both Islamic and Conventional finance are subject to the same rules in Saudi Arabia under the main legal bodies (Saudi Arabian Monetary Agency (SAMA), and Capital Market Authority (CMA) **,**in Saudi Financial Market?

(14) Considering that there is no specific rule and law regarding *sukuk* in Saudi Arabia, what are the consequences of this on the issuers, *sukuk* holders and Saudi Market?

(15) How can these risks be managed?

(16) Do you think CRSD and ACRSC have the power to resolve disputes between issuers and *sukuk* holders as those committees have nothing to do with the *Shari'ah* courts, and their members are not members of the judiciary system?

(17) Do you think the decision of these committees in the financial dispute is binding on both issuers and *sukuk* holders or the final decision is based on *Shari'ah* courts?

(18) Could you surmise what are the main legal risks associated with *sukuk* issued in Saudi Arabian Market?

(19) Finally; what have been the consequences of legal risks faced by Saudi *sukuk* structures?

Questions for Specialists in Islamic Finance and *Sukuk*

(1) What is the importance of the *Shari'ah* supervisory boards?

(2) What are the advantages and purpose of having SSB in Islamic finical institutions?

(3) What is the concept of *Shari'ah* supervisory board?

(4) What is the function of the *Shari'ah* boards in *sukuk* issuance?

(5) What are the steps of issuing the *fatwa* on the *sukuk* structures?

(6) What are the consequences of changing the *fatwa* from SSB?

(7) What are the criteria of the SSB Members?

(8) What are the advantages of applying and observing standards such as AAOIFI by the SSBs?

(9) What is your comment on the call that SSB member should be accountable for their negligence?

Appendix 2

INTERVIEW QUESTIONS (ARABIC)

أولاً: الهيئة الشرعية:

1. ماهو دور الهيئة الشرعية في صياغة هيكلة الصكوك، هل تقوم الهيئة بصياغة هيكلة الصك؟ أم تقوم فقط بمراجعة و اعتماد الصيغة المقدمة لها؟
2. هل تتطلع الهيئة الشرعية على جميع المستندات ذات العلاقة بإصدار الصكوك (التعهد بالشراء، اتفاقية تحويل ملكية موجودات الصكوك، اتفاقية إدارة موجودات الصكوك .... وغيرها)؟
3. ماهي المستندات التي تقوم الهيئة الشرعية بالإطلاع عليها قبل إصدار الفتوى؟
4. هل تلتزم الهيئة الشرعية بالمعايير الصادرة عن آيوفي؟
5. هل تقوم الهيئة الشرعية بالإشراف و المتابعة والمراقبة على التنفيذ كما هو مطلوب في معايير آيوفي؟
6. كيف يتم إتخاذ قرارات الهيئة الشرعية، بالتصويت أم بالإجماع؟
7. هل تؤيدون وجود معايير شرعية موحدة لإصدار الصكوك (كمعايير آيوفي)؟
8. هل هنالك اشكاليات و معوقات في تطبيق معايير آيوفي في السعودية؟ و ماهي؟
9. كما تعلمون قد تتغير الفتوى قبل انتهاء مدة الصك (وأحياناً من نفس الهيئة الشرعية التي أجازت الصك)، ماهو المطلوب من حامل الصك؟
10. هل هناك إلتزام معلن بمبادئ الشريعة في نشرة الإصدار ؟

الهيكلة :

1. ماهي هيكلة صكوك سابك، و ماهو طبيعة العقد؟
2. هل يجب أن يتم ذكر طبيعة (صيغة) العقد في نشرة الإصدار؟(لان المذكور صكوك تسويق فأي نوع من انواع العقود تدخل تحته)؟
3. كيف تختلف الصكوك التي أصدرتها سابك عن السندات التقليدية التي أصدرتها سابقاً؟
4. من هم أطراف العلاقة في صكوك سابك، و ماهي واجباتهم و حقوقهم و هل يجب أن توضح في نشرة الإصدار؟
5. هل هنالك فصل في الذمة المالية (الالتزامات المالية) بين سابك وشركاتها التابعة التي تبرم معها عقود التسويق؟ و هل يتطلب ذلك أم لا؟
6. هل يحصل متعهد التغطية والذي هو في الغالب (البنك) على عمولة نظير تعهده وظمانه؟ وهل هناك محظور شرعي في ذلك ؟
7. هل هنالك مشاركة حقيقية في الغنم و الغرم بين حاملي الصكوك ومصدر الصكوك؟
8. هل تحديد العائد على الصكوك يتم بناءاً على موجودات الصكوك و الإيرادات المتوقعة من الموجودات؟ أم بناءاً على الملائة المالية للمصدر (كالسندات التقليدية)؟
9. لماذا تراعى الملائة المالية للمصدر بدلاً من موجودات الصكوك؟ علماً بأن موجودات الصكوك و ايراداتها مستقلة عن مصدر الصك (سابك).

موجودات الصكوك :

1. ماهي موجودات صكوك سابك؟
2. هل هنالك انتقال حقيقي لموجودات الصكوك لصالح حملة الصكوك؟ و كيف يكون الانتقال الحقيقي للأصول لصالح حملة الصكوك من منظور شرعي؟
3. هل العائد/الربح الدوري الذي يحصل عليه حاملو الصكوك ناتج عن و يتوافق مع موجودات الصكوك؟ أم فقط يحدد بناءاً على أسعار الفائدة في السوق و ليس على طبيعة موجودات الصكوك؟
4. يلاحظ أن العوائد التي يحصل عليها حاملو الصكوك ترتبط أساساً بمعدل الفائدة في السوق و بالملائة المالية لمصدر الصك. ألا يوحي ذلك بصورية موجودات الصكوك؟
5. يلاحظ أيضاً أن قيمة الصكوك بعد تداولها في السوق الثانوية لا تتأثر بقيمة موجودات الصكوك إرتفاعاً و إنخفاضاً، بل تتأثر بالدفعات الدورية للصكوك و أسعار الفائدة السائدة في السوق. ألا يوحي ذلك أيضاً بصورية موجودات الصكوك؟
6. تدار موجودات الصكوك من قبل المصدر (سابك)، كما أن أمين موجودات الصكوك هي شركة تابعة للمصدر، ألا يوحي ذلك بصورية هيكلة الصكوك، حيث أن حملة الصكوك ليست لديهم أصول ملموسة يمكن الرجوع إليها في حالة إفلاس أو إخفاق المصدر في إلتزاماته تجاههم؟
7. في حالة إفلاس سابك، أو إخلالها بالتزاماتها تجاه حملة الصكوك، ماهي طبيعة الموجودات التي يمكن الرجوع إليها من قبل حاملي الصكوك؟
8. هل تقوم سابك بصفة مستمرة بإبرام عقود تسويقية مع شركاتها التابعة، أم فقط تقوم بذلك عند الحاجة لخلق موجودات لإصدار الصكوك (صورية الأصول)؟

ضمان رأس المال و العوائد (استرداد الصكوك) :

1. هل يحق لمصدر الصك (سابك) التعهد لحاملي الصكوك بشراء موجودات الصكوك بالقيمة الإسمية؟ او بنسبة محددة مثل (90%)في فترة محددة ؟
2. تعطي سابك حاملي الصك الحق بإسترداد الصكوك كل (5 سنوات) بالقيمة الإسمية. علماً بأن ذلك يخالف معايير آيوفي؟ ماهو رأيكم؟
3. بعد انتهاء مدة الصك، هل يجب على حاملي الصكوك إرجاع موجودات الصكوك لمصدر الصك بالقيمة الاسمية؟
4. ماهو مصدر الدفعات لحملة الصكوك؟
5. لماذا لا يحق للمصدر ضمان رأس المال و العوائد، بينما يحق لطرف مستقل أن يقوم بضمان رأس المال لحاملي الصكوك؟
6. هل يحق للدولة (أو أي من مؤوسساتها) ضمان رأسمال صكوك سابك كطرف مستقل، علماً بأنها تتملك 70% من رأسمال سابك؟
7. تعتبر سابك تأخيرها في تسديد أي من التزاماتها المالية تجاه اللغير حالة من حالات الإخفاق تجاه حملة الصكوك، و بناءاً عليه يحق لحملة الصكوك مطالبة سابك باسترداد الصكوك بالقيمة الاسمية. اليست موجودات الصكوك و ايرادتها مستقلة عن سابك (ليست التزامات مالية على سابك)؟
8. عدم دفع مبلغ التوزيع الدوري يعتبر حالة من حالات اخفاق سابك تجاه حملة الصكوك وفي هذه الحالة يحق لحملة الصكوك مطالبة سابك بإعادة المبلغ وإعادة شراء الصكوك بالقيمة الاسمية، مما يعني أن سابك ملزمة بدفع التوزيعات الدورية لحملة الصكوك. ماهو تعليقكم؟
9. لماذا تصنف سابك الصكوك التي تصدرها على أنها ديون في قوائمها المالية؟ و ماهو تعليقكم على ذلك؟

احتياطي الأرباح (معدل التوزيع) :

1. ماهو رأيكم بوجود احتياطي للأرباح يدار من قبل مصدر الصكوك (مدير موجودات الصكوك) ؟
2. هل يتم توضيح معدل الأرباح الدورية لحملة الصكوك؟ و توضيح مبلغ احتياطي الأرباح لحملة الصكوك؟
3. مدير الموجودات (الذي هو مصدر الصكوك أيضاً) يحق له التصرف باحتياطيات الأرباح لحسابه الخاص , وتؤول له جميع المبالغ التي في الاحتياطي في آخر المدة كحافز (وذلك في حالة التزامه بالمدفوعات الدورية لحملة الصكوك). ماهو تعليقكم؟
4. نتيجة أن احتياطي الأرباح تؤول للمصدر (أو مدير الموجودات) ونسبة الربح محددة مقدماً فإن ربح حاملي الصكوك محدود (له حد أعلى، حسب ماهو متفق عليه في نشرة الإصدار)، و الخسارة غير محدودة، بينما مصدر الصك يحصل على تمويل بدون تحمله أي مخاطر أو أي التزامات بتسديد المدفوعات الدورية (فقط من موجودات الصكوك). ماهو تعليقكم؟
5. معلوم أن الصكوك تتداول في الأسواق الثانوية، فكيف يتم تحديد حصة حملة الصكوك الجدد من احتياطي الأرباح؟ هل الاحتياطي ملك للبائع أم للمشتري؟

الغرر :

1. كيف تقوم موجودات الصكوك ويعرف قيمتها السوقية ؟
2. هل القيمة السوقية لموجودات الصكوك مساوية فعلاً لقيمة الشراء الذي يدفعه حملة الصكوك؟
3. هل يعلم حملة الصكوك ماهي القيمة الفعلية (السوقية) لموجودات الصكوك، وماهي الإيرادات المتوقعة من هذه الموجودات، وماهي طبيعة العقود المبرمة (ذات العلاقة بموجودات الصكوك) بين سابك وشركاتها التابعة، وماهي الشركات التابعة لسابك التي تُبرم معها العقود التسويقية؟
4. في حالة أن هنالك إختلاف كبير جداً بين القيمة الاسمية و القيمة السوقية لموجودات الصكوك عند انتهاء مدة الصكوك، هل يحق لحملة الصكوك الرجوع على المصدر لتعويضهم نتيجة للغرر الذي لحق بهم؟
5. هل هنالك غرر في معاملة الصكوك (عدم معرفة موجودات الصكوك، قيمتها السوقية، إيراداتها)؟

موجودات الصكوك، و استخدام متحصلات الإكتتاب :

1. هل يجب أن تكون موجودات الصكوك متوافقة مع الشريعة 100%؟ وماهو رأيكم في من يرى أن موجودات الصكوك الغير متوافقة مع الشريعة يجب أن لا تتجاوز 33% من قيمة موجودات الصكوك؟
2. هل يجب أن تستخدم متحصلات الاكتتاب لأغراض متوافقة مع الشريعة 100%؟ وماهو رأيكم في من يرى أن استخدام متحصلات الاكتتاب الغير متوافقة مع الشريعة يجب أن لا تتجاوز 33% من القيمة الاجمالية لاستخدام متحصلات الاكتتاب؟

المخاطر والمعوقات :

1. من وجهة نظركم، ماهي المخاطر الشرعية للصكوك؟ و كيف يمكن إدارة هذه المخاطر؟
2. هل هنالك عقبات في اصدار الصكوك عموماً و في السعودية خصوصا؟ ماهي؟ وكيف يمكن حلها؟
3. كيف تتعاملون مع المعايير المحاسبية الدولية و المحلية؟ هل هنالك تصنيف محدد لكيفية التعامل مع الصكوك أم تعتبرها المعايير المحاسبية مديونية على الشركة (تعاملها كالسندات)؟
4. كيف تتعاملون مع البيئة التشريعية و القانونية في المملكة؟ هل تصنف الصكوك كأدوات دين أم أدوات استثمار؟

الأسئلة الخاصة بالقضايا القانونية

(1) ماهي الفروق الاساسية بين السندات والصكوك من الناحية القانونية؟

(2) *هل الصكوك المصدره في السعودية صكوك لها اصول حقيقية ام انها فقط مدعومة بأصول؟*

(3) هل حملة الصكوك لهم الحقوق الكامله والتصرف المطلق على اصولهم؟ وبمعنى اخر هل انتقال الملكية من المالك الاصلي الى حملة الصكوك تم بطريقة سليمة من الناحية القانونية؟

(4) لو حصل هناك افلاس ماهو الموقف القانوني لحملة الصكوك؟

(5) كيف يمكن لحملة الصكوك المطالبة بحقوقهم؟

(6) هل هناك قانون خاص بالافلاس والاعسار ؟

(7) ماهي المخاطر التي ربما تحصل في هذه الحالة؟

(8) كيف يمكن التعامل مع المخاطر في ظل غياب القانون الخاص بالصكوك في السعودية من ناحية الاجراءات والانظمة والتي بناء عليها حملة الصكوك يستطيعون المطالبة بحقوقهم؟

(9) هل تعتقدون ان هناك نقص في اعداد المتخصصين في المالية الاسلامية والذين يجمعون بين الشريعة والقانون وخاصة بما يتعلق بالصكوك؟

(10) ماهي الاثار المترتبة على سوق الصكوك؟

(11) ماهي الاثار القانونية للمخاطر التي تحصل من جراء الاختلاف في الفتوى بين الجهات المصدرة لها؟

(12) ماهي الاثار المترتبة على الاختلافات في الفتوى بين الهيئة الشرعية التي اقرت صكوك سابك وبين لجان الفصل في منازعات الاوراق المالية؟

(13) هل صحيح ان المعاملات التقليدية والاسلامية تخضع لنفس القوانين والانظمة على حد سواء الصادرة من السوق المالية؟

(14) ماهي الاثار القانونية التي ربما تؤثر على حملة الصكوك والمصدرين في ظل غياب قانون الصكوك؟

(15) كيف يمكن معالجة هذه الاثار؟

(16) هل تعتقدون ان لجان الفصل في المنازعات لها القوة في حل اي خلاف ناتج بين حملة الصكوك والمصدرين لان هؤلاء الاعضاء ليسوا من السلك القضائي؟

(17) هل تعتقدون ان قرارات لجان الفصل ملزمه للمصدرين وحملة الصكوك او ان القرار النهائي خاص بالمحاكم الشرعية؟

(18) هل ممكن تخمين ماهي المخاطر القانونية المتعلقة بالصكوك المصدرة في السوق السعودي؟

(19) أخيرا ماهي الاثار النترتبة على المخاطر القانونية التي تواجهها الصكوك المصدرة في السوق السعودي؟

الاسئلة الخاصة بالمتخصصين في المالية الاسلامية

(1) ماهي اهمية الهيئات الشرعية؟

(2) ماهي فوائد واهداف تعيين هيئات شرعية في المؤسسات المالية الاسلامية؟

(3) ماهو مفهوم الهيئة الشرعية؟

(4) ماهي وظيفة الهيئة الشرعية في عملة اصدار الصكوك؟

(5) ماهي خطوات اصدار الفتاوى في عملية اصدار الصكوك؟

(6) ماهي الاثار المترتبة على تغيير الفتوى؟

(7) ماهي صفات اعضاء الهيئة الشرعية؟

(8) ماهي الفوائد من تطبيق معايير للصكوك مثل الايوفي للهيئات الشرعية؟

(9) ماهو تعليقك على الدعوات التي تنادي بمحاسبة الهيئات الشرعية عند تقصيرها؟